United States District Court
For the Northern District of California

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

IN RE:

PATRIOT AMERICAN HOSPITALITY, INC, SECURITIES LITIGATION,

Master File No MDL No 1300

ORDER

This Document Relates To:

Johnson v Patriot American Hospitality, Inc, C 99-2153 VRW

Ansell v Patriot American Hospitality, Inc, C 99-2239 VRW

Gunderson v Patriot American Hospitality, Inc, C 99-3040 VRW

Sola v Paine Webber Group, Inc, C 99-3966 VRW

Susnow v Patriot American Hospitality, Inc, C 00-0947 VRW

Szekely v Patriot American Hospitality, Inc, C 00-0875 VRW

Levitch v Patriot American Hospitality, Inc, C 00-0948 VRW

Gallagher v Patriot American Hospitality, Inc, C 00-0949 VRW

Meisenburg v Patriot American Hospitality, Inc, C 00-1478 VRW

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On July 1, 1997, Patriot shares traded at around $44 dollars per share. Patriot shares now trade for about $2.30 per share. Against this background, nine securities fraud class action suits are before the court. The cases have been consolidated into two actions, the "Merger Action" and the "Open Market Action." Defendants have moved to dismiss both actions for failure to state a claim. FRCP 12(b)(6).

I

A

Patriot was founded in 1991 by defendant Paul Nussbaum for the purpose of owning hotel properties; the company went public in 1995. In July 1997, with the assistance of Paine Webber, a defendant in the merger action, Patriot merged with Bay Meadows, an entity that enjoyed an unusual status under the Internal Revenue Code. Bay Meadows was a paired stock consisting of the California Jockey Club (CJC) and Bay Meadows Operating Company (BMOC).

After the merger, Patriot spent over $5.5 billion to purchase hotels and related businesses and incurred over $3.8 billion in debt. A portion of this debt was in the form of forward equity contracts. By late 1998, however, Patriot started to default on loans, was forced to sell off assets and finally had to agree to a $1 billion equity investment in return for up to 52% of the company. By April 1999, Patriot stock was down to approximately $5 per share.

Former Bay Meadows shareholders who became Patriot shareholders in the July 1997 merger bring the merger action. These plaintiffs allege that Patriot failed to disclose in the merger proxy statement that Patriot planned to take on massive amounts of debt, enter into the forward equity transactions and acquire numerous hotel properties. Plaintiffs further allege that

Patriot failed to disclose conflicts of interest between Patriot and Patriot's underwriter, Paine Webber, which issued a fairness opinion in connection with the merger transaction. Finally, plaintiffs allege that the fairness opinion by Paine Webber was misleading.

Plaintiffs in the merger action allege causes of action under section 10(b) of the Securities Exchange Act of 1934 ('34 Act), 15 USC § 78j(b); section 11 of the Securities Act of 1933 ('33 Act), 15 USC § 77k(a); section 12(2) of the '33 Act, 15 USC § 77*l*(a)(2); and section 14(a) of the '34 Act, 15 USC § 78n(a). Plaintiffs name Patriot American Hospitality, Inc; Wyndham International, Inc; PAH GP, Inc; PAH LP, Inc; Patriot American Hospitality Partnership, LP; and Wyndham International Operating Partnership, LP (together the Patriot defendants). Plaintiffs also bring suit against Paine Webber Group Inc (Paine Webber).

The open market action is brought against Patriot American Hospitality, Inc, Wyndham International, Inc, Paul A Nussbaum and James D Carreker. Open market plaintiffs purchased or otherwise acquired their shares between January 5, 1998, and December 17, 1998. The open market plaintiffs bring suit under section 10(b) of the '34 Act and section 20(a) of the '34 Act. Plaintiffs in the open market actions allege that defendants put false or misleading information into the market distorting the price of the stock and causing them to pay more for the stock than it was worth. The alleged misstatements relate to Patriot's ability to pay its debt, integrate newly acquired hotels, cut costs and grow internally after the passage of unfavorable legislation made continued growth by acquisition impossible.

In the merger action, the Patriot defendants and Paine Webber have filed separate motions to dismiss but have joined each other's motions. Some of the defenses raised are applicable to all four causes of action while others are specific to one or more causes of action. The open market defendants have also filed a motion to dismiss in that action. Also before the court is plaintiffs' motion to strike exhibits B-D to the declaration of Sean E O'Donnell submitted in support of defendants' motion to dismiss the open market complaint.

In a FRCP 12(b)(6) motion, all material allegations in the complaint must be taken as true and construed in the light most favorable to the plaintiff. See In re Silicon Graphics Inc Sec Lit, 183 F3d 970, 980 n10 (9th Cir 1999). In accordance with FRCP 12(b)(6), the factual recitals herein come from the complaints in the two actions.

Dismissal is appropriate if it "appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." Conley v Gibson, 355 US 41, 45-46 (1957). When a complaint is dismissed for failure to state a claim, "leave to amend should be granted unless the court determines that the allegation of other facts consistent with the pleading could not possibly cure the deficiency." Schreiber Distrib Co v Serv-Well Furniture Co, 806 F2d 1393, 1401 (9th Cir 1986).

Defendants also rely on the particularized pleading standards of FRCP 9(b), the Private Securities Litigation Reform Act of 1995 (PSLRA), 15 USC § 77z-1 et seq, § 78u-4 et seq, and the

Ninth Circuit's decision in Silicon Graphics.

B

The pleadings ascribe the motive for Patriot's merger with Bay Meadows as a desire to obtain Bay Meadows' unique structure as a paired REIT and operating company. Prior to the merger at issue here, CJC owned a horse race track in San Mateo County and was structured as a real estate investment trust (REIT). Merger Complaint at ¶ 3. REITs pay no federal income tax as long as they distribute to shareholders 95 percent of earnings. To qualify as a REIT, a company may only own assets; it cannot operate or manage a business. Id at ¶ 49. BMOC conducted the horse racing and related entertainment business at CJC's race track. BMOC leased the track and made lease payments to CJC. This structure, barred by Congress in 1984, allowed an entity to avoid the usual double taxation that results when a corporation pays dividends to its shareholders. Id at ¶ 4, 5. Bay Meadows was one of a small number of entities exempted by Congress from the prohibition on the paired-share structure enacted in 1984. Id at ¶ 6. Bay Meadows consistently paid a dividend to its shareholders and at the time of the merger had no debt on its books. Id at ¶ 59, 61.

The initial merger agreement between Patriot and Bay Meadows was entered into on October 31, 1996. Id at ¶ 72. On February 24, 1997, a superseding merger agreement was entered into by the parties. Id at ¶ 79. In between these agreements, Patriot announced its acquisition of several new hotels. Id at ¶ 74, 75. After the agreement, the acquisitions continued. On April 14, 1997, Patriot announced that it would acquire Wyndham and 11 hotels from Trammell Crow. Id at ¶ 84. Patriot also announced on April 14 that it had signed a commitment for a $1.4 billion line of credit. Id at ¶ 85. On May 29, 1997, Patriot announced that it had replaced its $1.4 billion secured line of credit with a $1.2 billion unsecured line of credit. Id at ¶ 87. On June 2, 1997, Bay Meadows and Patriot issued a Joint Proxy Statement and Prospectus to all their shareholders. Id at ¶ 89. It is the alleged false statements and misleading omissions of this proxy statement that are the subject of plaintiffs' claims in the merger action.

II

The merger plaintiffs have brought claims under sections 10(b) and 14(a) of the '34 Act and sections 11 and 12(2) of the '33 Act. Section 10(b) of the '34 Act states that it shall be unlawful "for any person * * * [t]o use or employ, in connection with the purchase or sale of any security * * * any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 USC § 78j(b). Rule 10b-5, promulgated under section 10(b) states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or the mails or of any facility of any national securities exchange,
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 CFR § 240.10b-5. To prevail under a section 10(b) claim,

plaintiffs must show "(1) a misrepresentation or omission of a material fact, (2) reliance, (3) scienter, and (4) resulting damages." Paracor Finance v General Electric Capital Corp, 96 F3d 1151, 1157 (9th Cir 1996).

Section 11 allows persons acquiring a security to sue for material misstatements or omissions in a registration statement. It provides:

> In case any part of the registration statement, when such part became effective, contained an untrue statement of material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue * * * .

15 USC § 77k(a).

Section 12(2) governs material misstatements or omissions in a prospectus. It states that:

> Any person who * * * offers or sells a security * * * by means of a prospectus or oral communication, which includes an untrue statement of material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable * * * to the person purchasing such security from him.

15 USC § 77*l*(a)(2).

Finally, section 14(a) "authorizes the Securities and Exchange Commission (SEC) to adopt rules for the solicitation of proxies, and prohibits their violation." Virginia Bankshares, Inc v Sandberg, 501 US 1083, 1086 (1991). Pursuant to its authority under section 14(a), the SEC promulgated rule 14a-9, which provides:

No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

17 CFR § 240.14a-9. In the merger action, plaintiffs have brought suit under all four of these sections and the rules implementing them. Each of the four causes of action that plaintiffs bring requires plaintiffs to plead and prove a material misrepresentation or omission.

The alleged false statements and misleading omissions of the proxy statement are contained in paragraphs 90 through 101 of the merger complaint. These alleged misrepresentations and omissions form the basis of all four causes of action in the merger action. In essence, plaintiffs allege that Patriot failed to disclose to shareholders that it had a single-minded strategy to obtain growth at all costs, through massive and risky undertakings of debt. Merger Complaint at ¶ 70. The merger plaintiffs claim the following five omissions and one misrepresentation:

• "[t]he proxy/Prospectus failed to disclose defendants' true intentions and business strategy to incur substantial debt, through massive short-term debt instruments and forward equity financing contracts, largely underwritten by defendant PAINEWEBBER." Id at ¶ 90.

• The representations about Patriot's debt "fail to tell the shareholders that substantially all of the $1.2 billion facility was already committed and would dramatically increase PATRIOT's debt, and that PATRIOT intended to increase such debt, at an exorbitant rate, in the succeeding months. Additionally, there are no disclosures about any additional costs, fees, points, prepayments penalties which is all material information." Id at ¶ 91.

• "PATRIOT planned to enter into forward equity contracts with the assistance of defendant PAINEWEBBER and failed to inform BAY MEADOWS's shareholders. * * * There are no disclosures of any forward equity contracts, nor the obligations incurred as a result of such debt by PATRIOT, in the Proxy/Prospectus." Id at ¶ 92.

• "While defendants disclosed the general nature of PAINEWEBBER's work for PATRIOT, the Proxy/Prospectus fails to disclose the existence of a conflict of interest, and indeed, explicitly makes the opposite conclusion: ' * * * Thus, neither Patriot nor Paine Webber believe that Paine Webber had any conflict of interest at the time that Paine Webber delivered the Paine Webber opinion.'" Id at ¶ 94.

• "[T]here was no discussion regarding the difficulty of achieving the results deemed necessary to warrant the higher value, nor was there any risk analysis." Id at ¶ 100.

• "PAINEWEBBER gave a misleading valuation of the true value of PATRIOT, upon its acquisition of the paired share structure from BAY MEADOWS, making it more attractive to the BAY MEADOWS shareholders than it actually was to induce the shareholders to vote in favor of the merger." Id at ¶ 99.

1

With respect to most of the alleged omissions, plaintiffs have failed to make a threshold showing that information was actually omitted. Defendants allegedly omitted to disclose: (1) defendants' intention to seek "aggressive growth" using debt financing, including forward equity financing; (2) that most of the credit available to defendants was already committed; (3) the terms of the new line of credit; and (4) a conflict of interest due to Paine Webber's dual role as advisor, lender, customer, on the one hand, and as issuer of the fairness opinion, on the other; and (5) the risk associated with Patriot's business plan and how difficult it would be to achieve the valuation Paine Webber forecast. The allegedly omitted information was, for the most part, disclosed in the proxy statement.

The proxy statement explicitly disclosed defendants' intention aggressively to acquire new hotel properties. See Request for Judicial Notice, Exh 1, Proxy at 5, 15, 44-45, 50, 53, and 64 (hereinafter Proxy). For example, the proxy statement said: "Patriot believes that market conditions remain favorable for the acquisition of additional hotels and hotel portfolios and it is expected that New Patriot REIT will continue Patriot's aggressive acquisition activities." Proxy at 5. The proxy statement also disclosed that defendants were increasing their line of credit to $1.2 billion. Id at 7, 15, 45, 58. Additionally, the proxy statement disclosed that "New Patriot REIT and New Patriot Operating Company also may borrow additional amounts from the same or other lenders in the future, or may issue corporate debt securities in public or private offerings." Id at 45. It further stated: "Patriot also may seek additional debt or equity financing prior to the consummation of the Merger." Id at 58.

The proxy did not explicitly disclose that defendants intended or planned to take on more debt or enter into equity forward contracts. Defendants' intention to employ debt or equity financing, however, is easily inferred from the proxy. The proxy explains that as a REIT, defendant was unable to use most of its revenues to finance its planned growth. Id at 53. The proxy stated: "As a result, if debt or equity financing were not available on acceptable terms, further acquisitions or development activities might be curtailed." Id. This disclosure, that acquisitions must be funded by debt or equity, plus the disclosure that Patriot intended aggressively to acquire property amounts to a disclosure that Patriot intended to take on more debt financing.

Only plaintiffs' claim that the proxy failed to disclose that "PATRIOT intended to increase such debt, *at an exorbitant rate*, in the succeeding months" remains viable in light of the disclosures of the proxy. Merger Complaint at 91 (emphasis added). Exactly what this allegation means is unclear. It might mean that defendants planned to take on debt at a certain rate, that they did not disclose that rate and that had they disclosed it, a reasonable investor would have deemed it to be exorbitant. Or, the claim might be that defendants knew the rate at which they planned to take on debt was exorbitant but they did not disclose this. Either way, plaintiffs would seemingly have a valid claim. But from the present complaint, the court cannot discern plaintiffs' intentions. Plaintiffs should amend their complaint to state their claim with respect to defendants' plans to take on debt more clearly. A claim that defendants planned to take on a lot of debt cannot succeed; the proxy disclosed this fact. But a claim based on either of the theories described above might succeed.

Plaintiffs' allegation that "PATRIOT planned to enter into forward equity contracts with the assistance of defendant PAINEWEBBER and failed to inform BAY MEADOW's shareholders," also survives this initial hurdle. Id ¶¶ 92. Nowhere in the proxy statement do defendants disclose that they intended to use equity forward contracts. This allegation may fail as a matter of law for other reasons, but it does not fail as a result of disclosure in the proxy.

Plaintiffs allege that most of the credit available to defendants was already committed. But this fact was disclosed adequately in the proxy statement. The proxy statement disclosed that $971 million of the $1.2 billion of credit available to defendants was already committed. The proxy described the new credit arrangement defendants entered into as consisting of a $500 million term loan that would be used to finance the acquisition of Wyndham and a $700 million revolving line of credit. Proxy at 71. The proxy stated that at the time the new credit arrangement was entered into, Patriot had outstanding debt of $471 million. Id at 45. Thus, $971,000 million of the new credit was already earmarked.

Disclosure of the amount of credit committed without adding up the amount and subtracting it from the total credit available is sufficient disclosure. See <u>In re Gap Sec Lit</u>, 1998 WL 168341 at *6 (ND Cal 1998) ("[W]here needed information may be derived through calculations of data provided by the corporation, a claim of material omission of fact will be dismissed."). Plaintiffs appear to concede this point as they have not addressed it in their opposition papers.

Plaintiffs are correct that defendants failed to disclose the terms of the new line of credit for which they contracted. Rather, the proxy explicitly declined to disclose those terms, stating: "While negotiations concerning the New Credit Facility are ongoing, there can be no assurance that such a credit facility will be obtained, or if obtained, when it will become effective or available or what the specific terms of such credit facility will be." Proxy at 7. Thus, this allegation by plaintiffs cannot be rejected at this point in the analysis.

Plaintiffs allege that defendants failed to disclose that a conflict of interest existed due to Paine Webber's dual role. But the proxy statement disclosed that dual role. It stated: "In the past, Paine Webber has provided financial advisory services and investment banking services and has acted as a lender, to Patriot (including acting as an underwriter for Patriot) and received fees for the rendering of these services." Id at 98. It further stated: "Paine Webber may provide financial advisory or investment banking services to, and act as an underwriter or placement agent for or lender to, Patriot, Cal Jockey or Bay Meadows in the future." Id. This information was also included in the fairness opinion rendered by Paine Webber. See Proxy Annex at F2-F3. Furthermore, the proxy statement and the fairness opinion both disclosed the proposed sale of Bay Meadow's land to Paine Webber's real estate affiliate. Proxy at 5, 64-65; Proxy Annex at F2-F3.

Plaintiffs do not dispute these disclosures but argue that "the true conflicts created by such relationship were never revealed to Bay Meadow's shareholders." Pl Opp Br (Patriot) at 9. But plaintiffs have not pointed to any facts that should have been disclosed but were not disclosed. Instead, plaintiffs' argument appears to be that defendants were required to state that there was a "conflict of interest." The securities laws, however, do not require defendants to state this conclusion. All that is required is that the facts from which this conclusion can be drawn be disclosed. See <u>Valley National Bank v Trustee for Westgate-California Corp</u>, 609 F2d 1274, 1282 (9th Cir 1979).

Finally, plaintiffs allege omissions related to Paine

Webber's estimated valuation of the Patriot shares post merger. Plaintiffs allege: "PAINEWEBBER gave a misleading valuation of the true value of Patriot." Merger Complaint at ¶ 99. Plaintiffs explain that the valuation was misleading because "[t]here was no disclosure that PAINEWEBBER had a conflict of interest due to its relationship with PATRIOT, as a beneficiary of the merger transaction. Additionally, there was no discussion regarding the difficulty of achieving the results deemed necessary to warrant the higher value, nor was there any risk analysis." Id at ¶ 100.

The alleged omission of the conflict of interest has already been rejected by the court. The omission of "the difficulty of achieving the results" and the omission of risk analysis, however, have not yet been addressed. Defendants do not argue that this alleged omission must be rejected because the information was actually disclosed.

In sum, defendants are largely correct that the omissions alleged in the complaint were actually disclosed by the proxy statement. After considering in detail the disclosures made in the proxy statement, only a few of plaintiffs' omission contentions remain viable. The contentions that remain are: (1) Patriot failed to disclose its intention to increase debt at an "exorbitant rate;" (2) Patriot failed to disclose the terms of its $1.2 billion credit facility; (3) Paine Webber's valuation of the post merger shares failed to disclose the risk and difficulty involved; and (4) Patriot failed to disclose its intention to use forward equity contracts.

2

Of these four remaining alleged omissions, two of those omissions suffer the same defect. The allegedly omitted information is immaterial, as a matter of law, because that information is speculative.

With respect to defendants' failure to disclose that it intended to use forward equity contracts to finance its hotel acquisitions is an actionable omission, the complaint does not allege the materiality of that information. Whether a piece of information is material is typically a factual question to be resolved by the trier of fact. TSC Industries, Inc, 426 US at 444 ("The determination [of materiality] requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts * * * and these assessments are peculiarly ones for the trier of fact."). But the law does not require the disclosure of speculation.

As previously noted, the proxy made plain that Patriot intended to embark on aggressive acquisition activities that of necessity required funding and pointed to the possibility of additional debt or equity financing. Plaintiffs do not allege that defendants knew at the time the proxy statement was circulated that they would use forward equity contracts to finance these aggressive acquisition activities. Defendants are alleged only to have failed to disclose an intention to use a particular type of debt. See Merger Complaint at ¶ 92. Absent from the complaint are allegations that would render the assumption of this particular type of debt a meaningful consideration. The allegation thus amounts to one that defendants failed to disclose speculation about a particular type of debt they intended to assume. Speculation about future events is not required. Desaigoudar v Meyercord, 223

F3d 1020, 1023-24 (9th Cir 2000). In that case the court stated: "Failure to disclose information that does not yet exist cannot be a predicate for Rule 14a-9 liability." Id at 1023.

Without allegation that some material significance attended the future use of forward equity contracts, the failure to include that alleged intention is immaterial. The proxy made extensive disclosures regarding the necessity of funding the planned aggressive growth. The court determines as a matter of law that defendants' omission of an intention to use forward equity contracts as opposed to some equivalent amount of other type of debt, even if true, was not material. Defendants' intention to use one particular kind of financing would not have altered the total mix of information available to the reasonable investor. Perhaps in an amended pleading, plaintiffs can allege that assuming this form of debt bears certain consequences that would render an intention to use it, as opposed to other forms of debt, a fact that would matter to investors. But the present pleading fails to include such allegations. The court will not speculate what might make this alleged omission material.

Similarly, the terms of the credit facility could not be disclosed because they were not yet determined when the proxy statement was issued. Disclosure of any expected terms would have been speculative and therefore immaterial. An estimation by defendants of what the terms might have ended up being was simply not material. Disclosure of this information would not "have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." TSC Industries, Inc v Northway, Inc, 426 US 438, 449 (1976). Plaintiffs do not even attempt to respond to defendants' argument about the immateriality of the terms of the credit facility. Instead, plaintiffs merely restate their complaint: "there was no disclosure about any additional costs, fees, points, or prepayments penalties." Pl Opp Br (Patriot) at 8. Omission of an intention to take on debt carrying particular terms or conditions might have significance if the terms or conditions would materially alter investors' assessment of Patriot's business prospects. As framed, the court finds the omission alleged immaterial as a matter of law, but will afford plaintiffs an opportunity to amend to allege that defendants' intentions with respect to forward equity contracts and the terms of the credit facility were material.

The omission relating to Paine Webber's valuation must also fail. Presumably, plaintiffs' argument is that disclosure of the risk/difficulty information was necessary to make the disclosed information, the valuation of $33-$39 per share, not misleading. But a valuation of the shares necessarily encompasses these items. If there was only a small chance that a valuation of $33 - $39 would be reached, then the valuation was not $33 - $39, it was some lower amount. The level of risk, or the difficulty of achieving success (essentially the same thing), do not need to be disclosed in order to make a valuation not misleading. Thus, the court finds that defendants had no duty to disclose the risk underlying its valuation. To the extent plaintiffs are alleging that Paine Webber's valuation failed to take into account how difficult it would be to achieve the valuation, that is a different claim. It is a claim that the valuation was itself false. That claim will be discussed below.

Finally, with respect to defendants' alleged intention to take on more debt, it is only an intention to take on debt at an "exorbitant" or unreasonable rate that plaintiffs can claim was undisclosed. As discussed above, the precise substance of this claim is unclear from the allegations of the complaint. In order to move forward on this claim, plaintiffs must clarify it. For this reason, the claim with respect to an intention to take on debt at an exorbitant rate is dismissed without prejudice.

In sum, all of plaintiff's omission claims as framed must fail as a matter of law. In addition to their claim under section 10 of the '34 Act, plaintiffs also allege violations of section 11, 12(a) and 14 of the '33 Act. Each of these claims requires plaintiffs to allege a material misrepresentation or omission. Desaigoudar v Meyercord, 223 F3d 1020, 1026 (9th Cir 2000) (holding that section 14(a) claims require a material misrepresentation); In re Verifone Sec Lit, 11 F3d 865, 868 (9th Cir 1993) (upholding district court's determination that claims under sections 10(b), 11 and 12 require an allegation of a material misrepresentation). Consequently, defendants' motion to dismiss must be GRANTED with respect to each claim. Furthermore, defendants' motion must be GRANTED with respect to each defendant. Since the deficiencies in the pleading cannot be remedied, the dismissals are with prejudice, except the dismissal with respect to the omission of defendants' alleged intention to use forward equity contracts or take on debt on terms that have some significance for Patriot's business prospects or to take on an *exorbitant* amount of debt. The dismissal of those claims is without prejudice to the filing of an amended pleading.

3

In addition to the alleged omissions, plaintiffs' complaint alleges one affirmative misrepresentation. The complaint alleges that Paine Webber "gave a misleading valuation of the true value of PATRIOT, upon its acquisition of the paired-share structure from Bay Meadows, making it more attractive to Bay Meadow's shareholders than it actually was in order to induce shareholders to vote in favor of the merger." Merger Complaint at ¶ 99. Defendants assert numerous defenses.

a

Defendants contend that plaintiffs lack standing to bring suit under sections 10, 11 and 12 because they did not purchase or sell a security as required under each of those sections. Defendants note that the challenged transaction was a reverse merger whereby Patriot was merged into Bay Meadows requiring the former Patriot shareholders, but not the Bay Meadows shareholders, to convert their shares. PW Br at 10 (citing Merger Complaint at ¶ 30). Bay Meadows shareholders merely held their shares. Merger Complaint at ¶ 79. Defendants argue that "plaintiffs 'neither purchased nor sold anything - the assets of the corporation in which they held stock merely changed character.'" PW Br at 10 (quoting JD Simmons, Inc v Alliance Corp, 79 FRD 547, 550 (WD Okla 1978)).

Defendants are correct and the parties agree that sections 10, 11 and 12 require a plaintiff to have purchased, acquired or sold a security. Section 10 requires a purchase or sale. Blue Chip Stamps v Manor Drug Stores, 421 US 723, 736 (1975). Section 11 gives a cause of action only to plaintiffs who acquire a security. 15 USC § 77k(a). Section 12 applies to plaintiffs who purchase a security. 15 USC § 77*l*(a). The parties also agree that "a person who exchanges his securities for a different security in a merger will ordinarily have 'purchased' or 'sold' for purposes of the securities laws." PW Reply BR at 3. Thus, the Patriot shareholders that exchanged their shares for shares in Bay Meadows indisputably would have standing. See <u>SEC v National Securities, Inc</u>, 393 US 453, 467 (1968). The issue here is whether the shareholders of the company merged into have exchanged their shares, i e, whether the Bay Meadows shareholders exchanged their shares. Plaintiffs contend that the Bay Meadows shareholders exchanged their shares for shares in the new Patriot entity. Defendants point out that the new Patriot entity was the same legal entity as Bay Meadows-only the name and asset holdings changed.

No case seems to have addressed this precise issue. The merger cases cited by plaintiff involved plaintiffs who exchanged their securities for shares in the other company in a merger. See <u>7547 Corporation v Parker & Parsely Development Partners, LP</u>, 38 F3d 211, 223 (5th Cir 1994); <u>In re Cendant Corp Lit</u>, 60 F Supp 2d 354, 366 (D NJ 1999); <u>Sanguinetti v Viewlogic Systems, Inc</u>, 1996 WL 33967 at *7 (ND Cal 1996). One of the cases, <u>Cendant</u>, contains the following relevant observation: "Because CUC was the surviving corporation, CUC shareholders did not exchange their stock as part of the merger." <u>Cendant</u>, 60 F Supp 2d at 359. This statement tends to reject plaintiffs' assertion that: "In effect, during the course of the merger, plaintiffs 'sold' their shares of Bay Meadows and 'purchased' shares in the newly formed Patriot American

Hospitality, Inc." Pl Br (PW) at 11.

It is unclear from the complaint whether Bay Meadows acquired Patriot's shares or merely its assets. But this is irrelevant to the present discussion "[s]ince the purchase or sale of stock by a corporation is not deemed to be a purchase or sale by the corporation's shareholders." Mosher v Kane, 784 F2d 1385, 1388 (9th Cir 1986), overruled on other grounds, In re Washington Public Power Supply System Sec Lit, 823 F2d 1349, 1350-51 (9th Cir 1987). Consequently, the court must address the thus far unanswered question whether the shareholders of the surviving company in a merger have standing to sue under sections 10, 11 and 12. The court takes guidance from the approach the United States Supreme Court took in National Securities. In finding that shareholders of the extinguished entity in a merger had standing, the Court took an expansive approach to the Blue Chip purchaser-seller requirement. It said: "Whatever the terms 'purchase' and 'sale' may mean in other contexts, here an alleged deception has affected individual shareholders' decisions in a way not at all unlike that involved in a typical cash sale or share exchange." National Securities, 393 US at 467. It continued: "The broad anti-fraud purposes of the statute [section 10] and the rule [10b-5] would clearly be furthered by their application to this type of situation." Id.

Similarly, the Ninth Circuit has stated: "Courts have generally recognized that this "purchase and sale" requirement should be read flexibly in order to effectuate the securities laws' remedial purposes." In re American Continental Corp, 49 F3d 541, 543 (9th Cir 1995). It also concluded that "courts have generally looked to the substance of the transaction rather than its form in determining whether a purchase and sale has occurred." Id. It is important to note that none of the cases finding a purchase or sale in the context of a merger share exchange has expressly differentiated between shareholders in the surviving corporation and those in the extinguished entity. While no case finds standing for shareholders in the extinguished corporation, none rejects it.

In this particular case, it would be anomalous to find standing on the part of Patriot shareholders but not on the part of Bay Meadows shareholders. The practical effect of the merger on Patriot shareholders was rather insignificant. In contrast, Bay Meadows shareholders suddenly became shareholders in the second largest hotel REIT in the country. If the purchaser-seller requirement were an inflexible rule, the outcome might be different. But given the flexibility with which the courts have applied the requirement, the court cannot conclude that the Bay Meadows shareholders lack standing.

b

Defendants allege that plaintiffs' suit is barred by the statute of limitations. Before the applicable statutes of limitations for each claim can be applied to the facts of this case, the court must determine the length of each limitations period and whether actual or mere inquiry notice starts the clock running.

The statute of limitations for the '33 Act claims and the 10(b) claim is 1 year. 15 USC § 77m; Lampf, Pleva, Lipkind, Prupis & Pettigrow v Gilbertson, 501 US 350, 364 (1991). The parties dispute whether the statute of limitations for section 14 and Rule 14a-9 claims is one year or three years. Plaintiffs would have the court look to state law in the absence of binding Ninth Circuit authority and find the statute of limitations to be 3 years. Defendants urge the court to follow Westinghouse Elec Corp v Franklin, 993 F2d 349, 353 (3d Cir 1993), and adopt the one year statute of limitations provided for by statute with respect to claims under sections 11 and 12. It turns out that even if the court were to adopt the one year statute of limitation, plaintiffs' claim would still not be barred. Thus, the court assumes without deciding that a one year statute of limitations period applies.

The next dispute is whether actual notice or mere inquiry notice will trigger the statute of limitations. By statute, inquiry notice is sufficient for section 11 or section 12 claims. 15 USC 77m ("No action shall be maintained to enforce any liability created under section 77k or 77*l*(2) of this title unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence."). The parties dispute whether actual notice or inquiry notice applies to the section 10 and 14 claims.

The court also need not answer this question because even assuming that inquiry notice is sufficient, defendants have not shown as a matter of law that plaintiffs should have been aware more than a year prior to the date the complaint was filed that Paine Webber's valuation was false, that defendants knew Patriot was taking on an exorbitant amount of debt or that defendants intended to take on debt by forward equity contracts or by particular credit terms. The Ninth Circuit stated that if it were to adopt an inquiry notice standard in the section 10(b) context, it would adopt "an inquiry notice standard coupled with some form of reasonable diligence requirement." Berry v Valence Technology, Inc, 175 F3d 699, 704 (9th Cir 1999) (quoting Sterlin v Biomune Sys, 154 F3d 1191, 1199-1200 (10th Cir 1998)). Applying this standard, the court cannot conclude as a matter of law that plaintiffs should have known about the alleged fraud more than one year prior to the filing of suit in this matter on May 7, 1999.

Defendants' statute of limitations argument turns on the public disclosures by Patriot of the acquisitions it was making, the debt it was taking on, the forward equity contracts it entered into and the land sale to Paine Webber. Patriot Br at 20; PW Br at 18-20. But these disclosures do not indicate that the Paine Webber valuation was in any way false (or knowingly false). The disclosures might have put plaintiffs on inquiry notice that defendants knew the rate at which Patriot was acquiring debt was exorbitant, that defendants' had intended to use forward equity contracts or particular credit terms that were unfavorable. But in light of the court's conclusion that these claims must be amended, the court concludes that it is best to decide these questions after an amended complaint has been filed. If plaintiffs amend the complaint with respect to the intention to take on debt at an exorbitant rate, use forward equity contracts and agree to particular credit terms, defendants' statute of limitation defense may need to be considered further. The court's conclusion at this point is only that the defense does not require dismissal with prejudice at this stage in the litigation. Thus defendants' statute of limitations argument cannot at this point succeed.[1]

c

Turning to the adequacy of the allegations supporting the misrepresentation claim, there is no dispute that the Rule 10b-5 cause of action is governed by FRCP 9(b) and the PSLRA and that scienter must be alleged. There is also no dispute that scienter need not be alleged for the section 11 and 12 claims. The parties dispute whether scienter, or mere negligence is required to allege a section 14 claim. It turns out, however, that because of the nature of the misstatement under consideration the court need not decide what mental state is required generally to prove a section 14 claim.

The misrepresentation is Paine Webber's valuation of the shares of the post merger entity. The valuation was part of a fairness opinion and was itself an opinion. As an opinion, the case law dictates that it can only be actionable under the securities laws if it was objectively and subjectively false. See <u>Virginia Bankshares, Inc v Sandberg</u>, 501 US 1083, 1095-96 (1991); <u>In re McKesson HBOC Inc Sec Lit</u>, No C 99-20743 RMW at 18-20 (ND Cal 2000); <u>Freedman v Value Health, Inc</u>, 958 F Supp 745, 752 (D Conn 1997). The Supreme Court in <u>Virginia Bankshares</u> stated: "A statement of belief may be open to objection only in the former respect, however, solely as a misstatement of the psychological fact of the speaker's belief in what he says." <u>Virginia Bankshares</u>, 501 US at 1095.

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[1] This outcome renders moot plaintiffs' objection to the consideration of the press releases and articles that defendants requested be judicially noticed.

While Virginia Bankshares was not on all fours with this case, In re McKesson, a case from this district, was very similar. There, an opinion about the fairness of a proposed merger was issued by an investment bank. In re McKesson, No C 99-20743 at 18. The court held that to state a cause of action under Rule 14a-9, a plaintiff must allege that the provider of the fairness opinion did not believe its opinion when made. Id at 19-20. The court reasoned:

> Rule 14a-9 prohibits only statements that are "false." The teaching of Virginia Bankshares is that an opinion is only false if the speaker does not in fact hold that opinion. * * * While material statements of fact are false if they are contradicted by true facts, material statements of opinion are false only if the opinion was not sincerely held.

Id at 19-20. The McKesson court then determined that the plaintiff in that case had failed to plead with particularity why the fairness opinion was knowingly false.

Plaintiffs argue that "Virginia Bankshares does not alter the holdings of other cases, such as Herskowitz, that an investment firm rendering a fairness opinion may be held liable upon a showing of negligence." Pl Opp Br (PW) at 16. Plaintiffs correctly read Herskowitz. See Herskowitz v Nutri/System, Inc, 857 F2d 179 (3rd Cir 1988). The Herskowitz court held that a fairness opinion is actionable "when an expert, in making a projection, adopts an assumption which the factfinder concludes was objectively unreasonable in the circumstances." Id at 185. The court, however, finds the Herskowitz court's conclusion to be contrary to the view expressed more recently by the Supreme Court in Virginia Bankshares. Consequently, the court follows McKesson.

In the case at bar, under the rule explained above, plaintiffs failed to plead a cause of action based on the fairness opinion and the valuation. There is no allegation that Paine Webber did not believe that the opinion it gave was correct. Plaintiffs have simply failed to plead a necessary element of their claim. The court notes that Virginia Bankshares and In re McKesson both involved claims under Rule 14a-9 while the case at bar also involves claims under sections 10, 11 and 12. In this instance, the same rule should apply to each claim. The McKesson court explained that an opinion is not false unless the speaker does not sincerely hold the opinion. Sections 10(b), 11 and 12 all require a false statement in order to state a claim. Since there is no false statement absent disbelief on the part of the speaker, the speaker's mental state is relevant even for these claims.

Consequently, all four of plaintiffs' claims based on the alleged misrepresentation of the value of Patriot shares must be dismissed. This dismissal is without prejudice. Even though the court concludes that dismissal of this claim is warranted, the court must still consider any arguments raised by defendants that if successful would result in dismissal with prejudice.

d

Patriot did not address in its briefs the alleged false valuation by Paine Webber. Patriot, instead, focused only on "four alleged omissions." Patriot Br at 9. Paine Webber, however, advances two more arguments that if accepted would compel dismissal with prejudice. The arguments are: (1) the valuation was immaterial as a matter of law; and (2) Paine Webber is not a proper defendant under sections 10(b), 11, 12 or 14. The first defense would warrant dismissal as to Patriot and Paine Webber while the second applies only to Paine Webber. Paine Webber's loss causation argument, even if accepted, would justify only dismissal without prejudice and therefore is not considered by the court at this time.

i

Paine Webber argues that its valuation of the post merger shares at between $33-39 per share was immaterial because during the period before the merger Bay Meadows shares traded at $44 per share. Paine Webber argues that any Bay Meadows shareholder that believed the allegedly misleading valuation would not have held onto the stock and voted for the merger but would rather have sold the stock at the higher price prevailing in the market.

Paine Webber fails to recognize, however, that a shareholder who believed Paine Webber would still take the valuation only for what it was -- an opinion. The believing shareholder would not necessarily have concluded that shares were really worth $33 to $39. A shareholder could have believed that Paine Webber honestly held this opinion and yet the shareholder might still have been motivated to hold onto the stock thinking that the market was a better arbiter of value than Paine Webber. Undoubtedly, Paine Webber's opinion about the stock's value would have altered the total mix of information available. See TSC Industries, Inc v Northway, Inc, 426 US 438, 449 (1976). For this reason, the court finds Paine Webber's materiality argument, with respect to the valuation, unpersuasive.

ii

Paine Webber also argues that it is an improper defendant under each of the sections of the '33 and '34 Act relied on by plaintiffs.

Section 11. In addition to other persons, section 11 makes liable any "person whose profession gives authority to a statement made by him who has with his consent been named * * * as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report or valuation, which purports to have been prepared or certified by him." 15 USC § 77k(a). By its plain language, section 11 appears to embrace Paine Webber in connection with the valuation it rendered which was referenced at pages 46 and 47 of the proxy.

Paine Webber makes no convincing argument to the contrary, relying instead, on a different part of section 77k(a)(4), which would require the portion of the proxy containing the valuation to have been prepared by Paine Webber. But the portion of section 77k(a)(4) quoted above lacks that requirement. Paine Webber does raise one possibly meritorious point. Paine Webber argues that plaintiffs have sued "Paine Webber Group Inc" while it was "Paine Webber Inc" that prepared the Fairness Report and valuation. If plaintiffs amend their claim against Paine Webber with respect to the valuation, plaintiffs can substitute the proper Paine Webber defendant. This matter does not warrant dismissal with prejudice.

Section 12. Section 12 applies only to a person who "offers or sells a security." 15 USC § 77l(a)(2). This requires at a minimum that a person "solicit" the purchase of a security. <u>Moore v Kayport Package Express, Inc</u>, 885 F2d 531, 535-36 (9th Cir 1989). A distinction is drawn between persons who solicit and those who "merely assist in another's solicitation efforts." Pinter v Dahl, 486 US 622, 651 n27 (1988).

Under this standard, it is clear that Paine Webber did not itself solicit Bay Meadows shareholders when it prepared a valuation of the post-merger shares in connection with a fairness opinion directed toward holders of Patriot stock. The Moore case makes clear that accountants are not liable for performing "professional services in their respective capacities as accountants * * * ." Moore, 885 F2d at 537. Without allegations that Paine Webber actively solicited, Paine Webber's alleged financial interest in the merger is irrelevant.

Consequently, the section 12 claim against Paine Webber is dismissed with prejudice.

Section 10. Paine Webber argues that "[n]o statement in the Proxy/Prospectus is a statement by Paine Webber." PW Br at 16. But the valuation was a statement by Paine Webber that was included in the proxy and that plaintiffs have alleged Paine Webber knew would be included in the proxy. Paine Webber concedes as much in its reply brief. See PW Reply Br at 14. Paine Webber's valuation is sufficient to give rise to section 10 liability by Paine Webber. See McGann v Ernst & Young, 102 F3d 390, 397 (9th Cir 1996).

Section 14. Section 14 makes it unlawful to "solicit or to permit the use of [one's] name to solicit any proxy" in violation of SEC rules. 15 USC § 78n(a). Liability under the use of a person's name prong requires a "substantial connection" between the use of the name and the solicitation. Yamamoto v Omiya, 564 F2d 1319, 1322-23 (9th Cir 1977). Paine Webber argues that it has not solicited or permitted Patriot to use its name to solicit.

Plaintiffs argue that a financial advisor that gives a fairness opinion can be liable under section 14. Plaintiffs' reliance on Kahn v Wien, 842 F Supp 667 (ED NY 1994), aff'd 41 F3d 1501 (2d Cir 1994), is misplaced. The court in Kahn did not hold that the real estate firm that gave a fairness opinion was liable under section 14. The question was not before the court because the parties had previously stipulated to the dismissal of the case against the real estate firm. Id at 677. Plaintiffs also rely on Herskowitz v Nutri/System, Inc, 857 F2d 179 (3d Cir 1988). The Herskowitz court did not consider the question whether a financial institution can be liable under section 14 for a fairness opinion, but it plainly assumed that liability was proper. See id at 189-90.

Paine Webber relies largely on Mendell v Greenberg, 612 F Supp 1543, 1552 (SD NY 1985). The case held that, as in the context of a section 12 claim, mere participation in the drafting of a proxy does not constitute solicitation. Id at 1552. The Mendell court also found that provision of a fairness opinion in connection with a merger did not constitute the use of the provider of the opinion's name in the solicitation effort. Id at 1551-52.

The court cannot conclude that the rule adopted by the Mendell court should control. The text of section 14(a) allows entities that permit the use of their name in a proxy solicitation to be liable for misstatements in the solicitation. The substantial connection test imposed in Yamamoto v Omiya, 564 F2d 1319, 1322-23 (9th Cir 1977), does not foreclose liability here. In the case at bar, unlike in Yamamoto, Paine Webber is alleged to have played a role in the drafting of the proxy solicitation. There is no question that Paine Webber had control over the valuation that went in the proxy. Courts have found a substantial connection on much weaker facts. See <u>Securities Exchange Comm'n v Falstaff Brewing Co</u>, 629 F Supp 62, 68-71 (DC Cir 1980); <u>Lewis v Byrnes</u>, 538 F Supp 1221, 1223-25 (SD NY 1982). Finally, a judge in this district has stated: "courts have allowed Section 14(a) claims against accountants and investment bankers, who are not soliciting proxies at all." See <u>In re McKesson Sec Lit</u>, C-99-20743-RMW at 21 (ND Cal Sept 28, 2000), PW Appendix of Unpublished Cases (Merger Action), Exh E.

Given the allegations of Paine Webber's involvement in the drafting of the proxy and the undisputed fact that the valuation was given by Paine Webber, it is fair to hold Paine Webber responsible for misstatements in the proxy related to that valuation.

In sum, the court concludes that plaintiffs' section 12 claim against Paine Webber based on the valuation and all of the omission claims against Paine Webber and Patriot (except with respect to exorbitant debt) must be dismissed with prejudice. The section 10, 11 and 14 claims based on plaintiffs' allegations concerning Patriot's undisclosed intentions concerning the rate at which it intended to increase debt and the alleged misrepresentation based on the Paine Webber valuation are dismissed without prejudice to plaintiffs' amendment of those claims in accordance with the foregoing.

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III

Plaintiffs in the open market action contend that defendants violated the securities laws by making materially misleading statements from January 5, 1998, to December 17, 1998. The statements are alleged to be misleading because they were untrue or because they omitted to disclose information necessary to make them not misleading.

To prevail on a claim under section 10(b) of the '34 Act, plaintiffs must allege and prove "(1) a misrepresentation or omission of a material fact, (2) reliance, (3) scienter, and (4) resulting damages." Paracor Finance v General Electric Capital Corp, 96 F3d 1151, 1157 (9th Cir 1996). In an action predicated on a fraud-on-the-market theory of liability, reliance is presumed. Basic, Inc v Levinson, 485 US 224, 245-47 (1988). Section 20(a) of the '34 Act, the provision under which plaintiffs' other cause of action in the open market complaint is brought, fixes liability on those who directly or indirectly control a person liable under the Act. As the violation alleged here is of section 10(b), the section 20(a) claim hinges on establishing the elements of a section 10(b) violation.

A

At all relevant times, defendant Nussbaum was the CEO of Patriot, Chairman of the Patriot board and a director on the Wyndham board. Open Market Complaint at ¶ 13. Defendant Carreker was the CEO and Chairman of the Board of Wyndham and a director of Patriot. Id. After the merger with Bay Meadows and the acquisition of Wyndham, Wyndham became Patriot's paired-share operating company. Between January 1997 and January 1998, Patriot increased the number of hotel rooms in its portfolio by over 500%. Id at ¶ 23. The class period in the open market action began on January 5, 1998, the day the completion of the Wyndham acquisition was announced. Id at ¶ 29. At the time of this acquisition, Patriot allegedly had "disbanded [its] internal audit team, which had been responsible for visiting properties and auditing financial and operational procedures" at those hotels. Id at ¶ 31.

On January 16, 1998, Patriot announced that it acquired a thousand plus room hotel for approximately $147 million. Id at 32. On February 3, 1998, Patriot stock traded at $26.50 per share and Nussbaum declared Patriot stock to be a "screaming buy." On February 12, 1998, Patriot announced fourth quarter 1997 results and extolled Patriot's integration with Wyndham and the potential for earnings growth driven by internal factors. Id at ¶ 35.

On February 27, 1998, Patriot announced its second forward equity contract, this one with NationsBanc Montgomery Securities, which resulted in gross proceeds of approximately $125 million. Id at ¶ 38. In March 1998, Patriot "lost its Chief Financial Officer" and sometime in early 1998 Wyndham's acting CFO took a sabbatical and eventually retired. Id at ¶ 25. On March 27, 1998, Patriot issued a press release discussing pending legislation that would prevent existing paired-share REITS from realizing the tax benefits conferred by that structure for properties acquired after March 26, 1998. Patriot announced that its acquisition of Interstate would not be affected by the pending legislation due to transitional relief the legislation provided for and that the "proposed legislation will not deter Patriot from continuing its proven internal and external growth strategies which, in 1997, drove Patriot's market capitalization from $1.1 billion to more than $5 billion." Id at ¶ 41.

Another forward equity transaction was announced April 6, 1998. Id at ¶ 43. On May 4, 1998, Patriot announced positive financial results and touted "its successful integration of several completed acquisitions, including Wyndham." Id at ¶ 45. But then, on June 30, 1998, Patriot announced for the first time an intention to sell off "certain non-strategic assets." Id at ¶ 53. On July 9, 1998, an article in the "Heard it on the Street [sic]" column questioned Patriot's ability to manage its growth and noted that the acquisitions spree might be over due to the pending legislation and Patriot's inability to raise money. Id at ¶ 54. The same day, Patriot issued a press release emphasizing Patriot's long term potential, expected revenue growth and comfort with its current leverage. On July 22, 1998, in response to the new legislation, Patriot issued a statement emphasizing its "focus on internal growth opportunities." Id at ¶ 59. "Between June 30, 1998, and September 11, 1998, the price of Patriot's paired-shares fell to $11.50 per share from approximately $24.00 per share." Id at 52.

Patriot announced its decision to retain its paired-share structure and continued to emphasize internal growth. Asset divestitures were announced on November 9, 1998, and December 16, 1998. Id at ¶ 66, 72. Also on December 16, 1998, "Patriot announced a $1 billion equity investment by the Apollo Group." Id at ¶ 73. On the final day of the class period, December 17, 1998, Patriot shares decreased by 15%, closing at $6.75 per share. Id at ¶ 75.

B

Defendants move to dismiss the complaint pursuant to 15 USC § 78u, FRCP 12(b)(6) and FRCP 9(b). Defendants argue that the alleged misstatements and omissions are not actionable because: they are nothing more than claims of corporate mismanagement, they are forward looking and protected by the PSLRA safe harbor and the bespeaks caution doctrine, they are mere puffery, they are barred by the truth-on-the-market doctrine, scienter has not been pled adequately, falsity has not been pled with specificity and they are statements by analysts for which Patriot cannot be held liable. The court will examine each alleged misstatement or omission and determine if the defenses described above apply to the claims pled in the complaint. Before doing so, these defenses are described.

1

Mismanagement. It is well-established that mismanagement alone cannot give rise to a federal securities law violation. See Santa Fe Industries v Green, 430 US 462 (1977). Nor does failure to disclose mismanagement, by itself constitute a violation. In re Wyse Tech Sec Lit, 1990 WL 169149 at *2 (ND Cal 1990). But, "a complaint does allege an actionable misrepresentation if it alleges that a defendant was aware that mismanagement had occurred and made a material public statement about the state of the corporate affairs inconsistent with the existence of the mismanagement." In re Wells Fargo Sec Lit, 12 F3d 922, 927 (9th Cir 1993) (quoting Hayes v Gross, 982 F2d 104, 106 (3d Cir 1992)).

Forward Looking-Statements. The PSLRA created a safe harbor for so-called "forward-looking statements." The safe harbor provides that a person "shall not be liable with respect to any forward-looking statement, whether written or oral, if and to the extent that * * * the forward-looking statement is * * * identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." 15 USC § 78u-5(c)(1)(A)(i). A person is also not liable for a forward looking statement if "the plaintiff fails to prove that the forward-looking statement * * * was made with actual knowledge * * * that the statement was false or misleading." § 78u-5(c)(1)(B)(i) & (ii). Thus, to fall within the safe harbor, defendants must show that their statements were: (1) forward looking; (2) identified as forward looking; and (3) accompanied by meaningful cautionary language. Alternatively, defendants can fall within the safe harbor if they can show that (1) their statements were forward looking; and (2) plaintiffs have not pled facts indicating that the statements were made with actual knowledge of their falsity.

The PSLRA defines the following kinds of statements, amongst others, as forward-looking: a statement containing a projection of revenues, income, earnings, etc; a statement of the plans and objectives of management for future operations; a statement of future economic performance; any statement of the assumptions underlying or relating to any of the previously described statements. 15 USC § 78u-5(i)(1). Misrepresentations about or omissions of existing or historical facts do not qualify as forward looking statements. <u>Gross v Medaphis Corp</u>, 977 F Supp 1463, 1473 (ND Ga 1997); <u>In re Valujet, Inc Sec Lit</u>, 984 F Supp 1472, 1479 (ND Ga 1997).

The parties in this case dispute whether the safe harbor protects knowingly false statements. The statute itself provides some support for the notion that knowingly false statements can be protected under the first prong of the safe harbor if accompanied by meaningful cautionary language. See also In re Splash Tech Holdings, Inc, Sec Lit, 2000 WL 1727377 at *8 n6 (ND Cal 2000); Harris v IVAX Corp, 182 F3d 799, 803-804 (11th Cir 1999). But it is hard to imagine how the securities laws could condone a knowingly false statement. For example, if a corporate officer predicted a 10% growth in sales due to new advertisements set to air when he knew the ads had been pulled, the cautionary statement, "The ads might not air," should not insulate him from liability for his knowingly false statement. This is part of what the Gross and Valujet courts were getting at when they held that the safe harbor does not apply to omissions of historical facts that would render false the forward-looking statement.

In the end, the forward-looking statement safe harbor offers defendants little protection beyond what was already available under the bespeaks caution doctrine, which is described below. To the extent a defendant makes a good faith prediction and states the reasons why the prediction might not come true, his statement is not actionable.

Bespeaks Caution. "The bespeaks caution doctrine provides a mechanism by which a court can rule as a matter of law (typically in a motion to dismiss for failure to state a cause of action or a motion for summary judgment) that defendants' forward-looking representations contained enough cautionary language or risk disclosure to protect the defendant against claims of securities fraud." In re Worlds of Wonder Sec Lit, 35 F3d 1407, 1413 (9th Cir 1994) (quoting Donald C Langevoort, Disclosures that "Bespeak Caution," 49 Bus Law 481, 482-83 (1994)). "Only if a disclosure [is] so obvious that reasonable minds [cannot] differ can the issue of whether shareholders have been adequately cautioned about the risks be settled as a matter of law." Warshaw v Xoma Corp, 74 F3d 955, 959 (9th Cir 1996) (internal quotations omitted).

Plaintiffs argue that the cautionary language must be within the four corners of the document containing the forward-looking statements. A judge in this district recently rejected the four corners argument. See In re Splash Tech Holdings, Inc Sec Lit, 2000 WL 1727377 at *10 (ND Cal 2000); but see In re Cirrus Logic Sec Lit, 946 F Supp 1446, 1454 n3 (ND Cal 1996). The undersigned concludes that Splash correctly states the law and therefore rejects plaintiffs' four corners theory. Plaintiffs' argument fails to consider the basis of the bespeaks caution doctrine: the materiality and reliance requirements. See Provenz v Miller, 102 F3d 1478, 1493 (9th Cir 1995). Under the fraud on the market theory, the market is presumed to internalize all public information regardless of the source. See generally Basic, Inc v Levinson, 485 US 224 (1988). Thus, there is no need for the cautionary language to be in one document.

Puffery. Some courts have characterized vague statements of optimism as puffery and therefore held them not to be actionable under the securities laws. See, e g, Wenger v Lumisys, 2 F Supp 2d 1231, 1245-46 (ND Cal 1998). But the notion that statements of corporate optimism are not actionable as "mere puffery" finds little support in Ninth Circuit case law. Instead, the Ninth Circuit has repeatedly held that a statement of optimistic belief is actionable to the extent that it (1) is not genuinely believed; (2) has no reasonable basis; or (3) is undermined by undisclosed facts known by the speaker. See, e g, In re Apple Computer Sec Lit, 886 F2d 1109, 1113 (9th Cir 1989).

Truth-on-the-market. In a fraud-on-the-market case, "an omission is materially misleading only if the information has not already entered the market." In re Convergent Tech Sec Lit, 948 F2d 507, 513 (9th Cir 1991). "However, before the truth-on-the-market doctrine can be applied, the defendants must prove that the information that was withheld or misrepresented was transmitted to the public with a degree of intensity and credibility sufficient to effectively counterbalance any misleading impression created by insider[s'] one-sided representations." Provenz v Miller, 102 F3d 1478, 1493 (9th Cir 1996) (internal quotation marks omitted).

Whether the truth was revealed to the market is a question of fact. Thus, a court should find that the truth-on-the-market defense succeeds as a matter of law only if no rational jury could find that the market was misled. Provenz, 102 at 1493. Typically, the factual inquiry required is best undertaken at trial or on a motion for summary judgment. But where the facts showing that truth entered the market are disclosed in SEC filings and other materials of which the court can take judicial notice, a motion to dismiss based on truth-on-the-market is appropriate. See Rubin v Trimble, 1997 WL 227956 at *7 (ND Cal 1997).

Pleading falsity. Plaintiffs in a securities fraud action must comply with the pleading requirements of FRCP 9(b) and the PSLRA. FRCP 9(b) provides: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." The PSLRA states:

> In any private action arising under this chapter in which the plaintiff alleges that the defendant-
>
> (A) made an untrue statement of a material fact; or
> (B) omitted to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading;
>
> the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."

15 USC § 78u-4(b)(1). The PSLRA thus requires plaintiffs to explain why a statement was false or misleading.

Whether the PSLRA requires plaintiffs to set forth the <u>sources</u> of the facts pled is questionable. For complaints pled on information and belief, the PSLRA requires plaintiffs to plead the facts upon which that belief is formed. Two judges in this district have held that this requires the sources of the facts to be pled. See <u>In re Silicon Graphics, Inc Sec Lit</u>, 970 F Supp 746 763-64 (ND Cal 1997); <u>In re Splash Technology Holdings, Inc Sec Lit</u>, 2000 WL 1727377 (ND Cal 2000). According to the <u>Splash</u> court, it is not sufficient to allege a fact that would make a statement by defendant false; plaintiff must allege the source of the revealed fact. Id at *16. The pleading requirement for complaints pled on information or belief applies when a complaint "fails to demonstrate that plaintiffs have personal knowledge of the facts pled." <u>In re Splash</u>, at *12.

A number of other district courts have discussed this issue and there appears to be a split amongst them. See, e g, In re Theragenics Corp Sec Lit, 105 F Supp 2d 1342 (ND Ga 2000) (discussing cases coming to different conclusions); In re Nice Systems Ltd, Sec Lit, 135 F Supp 2d 551, 568-73 (D NJ 2001); In re Aetna Inc Sec Lit, 34 F Supp 2d 935, 941-43 (ED Pa 1999). Few courts of appeal, however, have addressed the issue. The Second Circuit took a middle position. See Novak v Kasaks, 216 F3d 300, 313 (2d Cir 2000). The Novak court held that plaintiffs were not required to reveal by name confidential sources that had provided the facts pled in the complaint. At one point the court indicated that the PSLRA categorically did not require plaintiffs to provide the source of their facts: "the applicable provision of law [§ 78u-4(b)(1)] as ultimately enacted requires plaintiffs to plead only facts and makes no mention of the sources of these facts." Id. But at other points, the court seemed to concede that plaintiffs must plead some sources of the facts pled, just not the names of confidential sources who are people. Id at 313-14. For example, the court said: "a complaint can meet the new pleading requirement imposed by paragraph (b)(1) by providing documentary evidence and/or sufficient general description of the personal sources of the plaintiffs' beliefs." Id at 314. A case from this district followed Novak. See In re McKesson HBOC, Inc Sec Lit, 126 F Supp 2d 1248, 1269-72 (ND Cal 2000).

The Ninth Circuit came close to addressing the issue in Silicon Graphics. In that case, the court considered the information and belief pleading requirement, but only did so in the context of pleading scienter, not with respect to pleading falsity. The court held that plaintiff was required to identify "from whom she obtained" internal documents that she relied on in alleging scienter. In re Silicon Graphics Inc Sec Lit, 183 F3d 970, 984 (9th Cir 1999). The court relied on section 78u-4(b)(1), which by its terms applies to pleading falsity as well as scienter. But the court's concern was directed at determining "whether there is any basis for the allegations that the officers had actual or constructive knowledge of SGI's problems that would cause their optimistic representations to the contrary to be consciously misleading." Id at 985. The court seemed to indicate that without information about the source of facts pled there can be no "strong inference" of scienter. Id.

Defendants in the case at bar have not raised the information and belief pleading requirement as a defense in their discussion of plaintiffs' pleading of falsity. Because defendants have not raised the issue and because there is no clear answer, the court declines to impose upon plaintiffs at this time a requirement that they specify the sources of their facts, in order to plead falsity.

Pleading Scienter. While plaintiffs may not be required to allege the sources of their allegations to plead falsity adequately, the source of the facts bearing on defendants' scienter is another matter. The scienter element in a securities fraud case requires plaintiffs to show that the defendants knew they made a material misstatement or were deliberately reckless as to the falsity of their statement. In re Silicon Graphics Inc Sec Lit, 183 F3d 970, 974 (9th Cir 1999). The PSLRA governs the pleading of scienter. It provides:

> In any private action arising under this chapter in which

> the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 USC § 78u-4(b)(2). In the Ninth Circuit, this provision has been interpreted as requiring that plaintiffs "must plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless conduct or conscious misconduct." Silicon Graphics, 183 F3d at 974. While "facts showing mere recklessness or a motive to commit fraud and opportunity to do so may provide some reasonable inference of intent, they are not sufficient to establish a *strong* inference of deliberate recklessness." Id.

Hence, plaintiffs' must plead the source of their allegations concerning scienter.

2

In paragraphs 29 through 75 of the complaint, plaintiffs attempt to set forth the elements of the two claims alleged and to satisfy the strict pleading standards of the PSLRA by quoting extensively from various press releases by Patriot and alleging the falsity of a number of these press releases. In each quoted press release, particular sentences are highlighted. At the end of the press release, plaintiffs allege that the statements contained within the release are false and give reasons for that allegation. This format makes it is difficult to link the alleged false statements with the reasons for their falsity. As discussed more fully later, this is a distinctly unhelpful approach to pleading the claims at bar. Nonetheless, the court will attempt to make this necessary linkage for each of the highlighted statements alleged to be false. Obviously, if plaintiffs fail to allege falsity, either in the form of an untruth or misleading omission, there can be no securities law liability for the statement. To the extent a statement is actually alleged to be false, the court will consider defendants' other defenses. For convenience, the false statements or misleading omissions highlighted in the complaint will be numbered sequentially.

<u>January 5, 1998, Press Release, ¶ 30.</u>

1. "The closing of our acquisition of Wyndham marks the culmination of months of strategic planning and painstaking attention to the long-term vision of this company."

2. "We now have a multi-branded company operating as Wyndham International which will manage the growth not only of the Wyndham brand, but our other brands which currently include Carefree Resorts, ClubHouse, Grand Bay, Registry and Grand Heritage."

3. "The necessary components are in place to facilitate rapid growth of the companies' multiple brands * * * we have worked closely with Patriot American to ensure that we were developing the best possible infrastructure to manage our growth and to increase shareholder value over the long term."

4. "Similar to consumer products companies, where each brand is supported by an entire division, we will shepherd the growth of our branded and non-branded hotel management business while the REIT continues to focus on mergers, acquisitions and asset management. With an excellent management team in place, as well as an outstanding portfolio of upscale properties, we are ready to move forward as a truly world-class hotel company."

5. "We are confident that the operational structure and systems we've taken time to create will enable us to make a relatively seamless transition as a significantly larger company with unparalleled growth potential."

Plaintiffs allege that these statements were false for the following reasons:

- Patriot lacked internal financial controls.
- Patriot had disbanded its internal audit team in 1996 and when the audit team came back in August 1998 it was undertrained

and understaffed.

- Profit Projection reports reflected improvements to Grand Bay/Carefree Resorts that never occurred and projected RevPAR was based on renovations that were not occurring.

- Patriot lacked a centralized computer system to permit downloading of sales information to corporate headquarters; Patriot had an unqualified and unstable regional management staff; Patriot canceled certain perks at its hotels (like free breakfasts).

- Budget Up-date Reports showed that Patriot could not pay its short-term debt from funds generated by its properties; these reports were sloppy.

Open Market Complaint at ¶ 31.

None of these allegations renders statements 1, 2 or 4 false. Statements 3 and 5, however, refer to components, operational structures and systems being in place. The complaint alleges that Patriot lacked internal financial controls, an audit team and a centralized computer system, all of which can be considered components, operational structures or systems. Thus, plaintiffs have alleged that statements 3 and 5 were false when made.

Both statements 3 and 5 have a forward-looking component to them; each predicts that future growth will be facilitated by structures and systems in place. But, the alleged omissions are of historical facts. Plaintiffs allege that certain components, operational structures and systems were missing at the time the statements were made. Thus, defendants can find no shelter in the safe harbor or from the bespeaks caution doctrine. Likewise, no truth-on-the-market defense is available here. Defendants' truth-on-the-market defense is premised on the market being aware of three things: (1) the risk associated with managing growth; (2) the risks associated with the forward equity contracts; and (3) the risks related to pending legislation.

Only the first category is implicated here. But knowledge by the market of risks related to growth is not the same as knowledge of particular shortcomings, as alleged here. Plaintiffs do not allege that Patriot withheld the fact that there was a risk; they allege the omission of specific facts that increase risk.

The court concludes that plaintiffs pled the falsity of statements 3 and 5. It must now consider whether falsity was pled with particularity as required by FRCP 9(b). The allegations related to internal financial controls, complaint at ¶ 31(a), contain one specific alleged falsity: by January 5, 1998, defendants had "isolated Patriot's Chief Financial Officer from evaluating the [company's] investments and acquisitions, thereby exacerbating the Company's lack of financial controls at the corporate level." The allegations about the internal audit team and the lack of a centralized computer system are also sufficiently specific in their allegation of falsity. No scienter allegations accompany these alleged misstatements, however. Thus, if plaintiffs are to plead a strong inference of scienter with respect to statements 3 and 5, they must rely on their general scienter allegations. Those general scienter allegations do not relate to the allegedly false statements. Plaintiffs will be given an opportunity to correct this deficiency.

<u>February 3, 1998, Press Release, ¶ 33.</u>

6. Patriot is a "screaming buy."

7. "In addition to boosting earnings through acquisitions,

Dallas-based Patriot American will also increase profit from the 463 hotels it already owns and operates."

8. "Patriot American's earnings from the hotels it now owns or operates will improve as it squeezes $100 million in cost savings from recently acquired hotels."

Plaintiffs allege these statements were false because:

- There was no realistic plan for cutting expenses and achieving $100 million in cost savings and that Patriot's short-term method of showing cost savings, cutting advertising, eliminating travel incentives and stalling on necessary renovations, would have the long term impact of elevated vacancy rates.
- Pending legislation would cause Patriot's stock price to drop.

Open Market Complaint at ¶ 34.

The fact that there was no cost savings plan in place makes statements 7 and 8 misleading. Fairly read, statements 7 and 8 amount to the same thing. Statement 7 predicts higher revenues, lower costs or both; statement 8 predicts lower costs. The falsity alleged is that lower costs could not reasonably be predicted because the company did not have in place a cost-saving plan. The allegation that the impending legislation would hurt Patriot, makes the statement 6 misleading. The effect of the pending legislation is an undisclosed fact that would undermine the optimistic belief expressed as "Patriot is a screaming buy."

Statements 7 and 8 are forward-looking. But the alleged omission relates to a fact allegedly known at the time of the statement. Thus, there can be no categorical protection under the safe harbor. Statement 6 is not forward-looking.

The truth-on-the-market doctrine cannot insulate defendants because the alleged omissions are not of the risks defendants claim were known by the market, but rather the omissions are of specific facts: that there was no cost saving plan that would work and that the legislation would cause the stock to drop.

Assuming the pleading of falsity is adequate, the complaint fails to plead facts giving rise to a strong inference of scienter. Plaintiffs cite no internal documents or communications indicating that defendants were aware that the legislation would cause a stock price drop, that the cost savings measures would not work in the long term and that the cost savings plan in general was not "realistic." The complaint simply asserts that these alleged facts were known. This is insufficient.

<u>February 12, 1998, Press Release, ¶ 35.</u>

9. Patriot released combined funds from operation (FFO) figures.

10. "In the months prior to the consummation of the merger, Patriot American and Wyndham Hotel Corporation worked closely together such that, when we closed the Wyndham merger on January 5, the integration process was well under way."

11. "The Companies expect earnings growth to be driven principally by internal factors, including growth in average daily rate (ADR), revenues per available room (RevPAR) and operating margins at the Companies' owned and leased hotels, as well as at the Companies' properties under management."

Plaintiffs allege falsity because:

- There were no procedures in place to integrate Wyndham and Patriot; there was no audit team; and Patriot relied on unaudited accounting statements of the acquired properties.
- Patriot's FFO figures were false because Patriot improperly avoided taxation on Wyndham's profits by having Wyndham pay excessive lease and overhead payments to Patriot.

Open Market Complaint at ¶ 36.

The allegation that Patriot's FFO numbers were calculated improperly makes statement 9 misleading. Statement 10 is false if the allegation that no integration procedures were in place at the time of the merger is true. The alleged faulty procedures with respect to the acquisition of Wyndham, however, do not speak to integration procedures. None of the allegations of paragraph 36 renders statement 11 misleading or false.

Statements 9 and 10 are not forward-looking. Nor do defendants' truth-on-the-market defenses apply here. Turning to defendants' pleading challenges, the court concludes that the pleading is inadequate. The falsity of statement 9 is pled; but the complaint does not make clear in what way the company's reported funds from operation were improperly reported. Additionally, plaintiffs fail to plead facts giving rise to a strong inference of scienter. No facts whatsoever are pled that would indicate that defendants knew improper tax evasion was occurring. With respect to statement 10, plaintiffs allege that no integration procedures were in place. Plaintiffs do not allege what kind of procedures Patriot lacked. Even if falsity were adequately pled, plaintiffs fail to allege any facts showing scienter. Plaintiffs fail to allege how defendants knew the integration procedures were lacking.

Hence, plaintiffs must allege with particularity the falsity of statements 9, 10 and 11, as well as facts giving rise to a strong inference of scienter with respect to each statement.

<u>February 27, 1998, Press Release, ¶ 38.</u>

12. "The terms of this placement [of paired shares] reflect our belief that paired shares are significantly undervalued today. Through the price adjustment mechanism, we are able to issue [forward] equity [contracts] today, enhancing our financial flexibility, while also retaining the ability to re-price the equity issuance during the coming twelve months."

Plaintiffs allege falsity because:

- Patriot lacked internal financial controls. ¶ 31(a).
- Patriot had disbanded its internal audit team in 1996 and when it came back in August 1998 it was undertrained and understaffed. ¶ 31(b).
- Profit Projection reports reflected improvements to Grand Bay/Carefree Resorts that never occurred and projected RevPAR was based on renovations that were not occurring. ¶ 31(c).
- Patriot lacked a centralized computer system to permit downloading of sales information to corporate headquarters; Patriot had an unqualified and unstable regional management staff; Patriot canceled certain perks at its hotels (like free breakfasts). ¶ 31(d).
- Budget Up-date Reports showed that Patriot could not pay its short-term debt from funds generated by its properties; these reports were sloppy. ¶ 31(e).
- There was no realistic plan for cutting expenses and achieving $100 million in cost savings and that Patriot's short-term method of showing cost savings, cutting advertising, eliminating travel incentives and stalling on necessary renovations, would have the long term impact of elevated vacancy rates. ¶ 34.
- Pending legislation would cause Patriot's stock price to drop. ¶ 34.
- There were no procedures in place to integrate Wyndham and Patriot; there was no audit team; and Patriot relied on unaudited accounting statements of the acquired properties. ¶ 36.
- Patriot's FFO figures were false because Patriot improperly avoided taxation on Wyndham's profits by having Wyndham pay excessive lease and overhead payments to Patriot. ¶ 36.
- Patriot did not disclose the true risk of forward equity contracts. ¶ 39(a).
- Patriot did not disclose that Paine Webber had advised against forward equity contracts. ¶ 39(b).

Open Market Complaint at ¶ 39 (referring to paragraphs 31, 34 and 36).

Plaintiffs fail to allege that the first part of the statement, that Patriot thinks its shares are undervalued, is false. Plaintiff does allege that the optimistic view of the forward equity contract is misleading. If defendants failed to disclose the risks of entering into the contracts, that might make the optimistic statement misleading. The court is unconvinced, however, that Patriot was required to disclose Paine Webber's recommendation not to use forward equity contracts. Absent a duty to disclose the information, which plaintiffs have not asserted existed, disclosure was only necessary if a failure to disclose rendered the statement made misleading. The court cannot from the pleadings conclude that this omission had that effect. This leaves plaintiffs' allegation that Patriot misleadingly failed to disclose the risks involved with the contracts.

Statement 12 is not forward-looking. But with respect to the risk of using forward equity contracts, the court concludes that defendants' truth-on-the-market defense is meritorious. Contrary to plaintiffs' assertions, the court can consider a truth-on-the-market defense at the motion to dismiss stage. See In re Stac Electronics Sec Lit, 89 F3d 1399, 1409-10 (9th Cir 1996). Patriot fully disclosed the risks of the forward equity contracts in its statements filed with the SEC. For example, Patriot's March 31, 1998, 10-K Annual report, states:

> On December 31, 1997, the Companies sold 3,250,000 unregistered Paired Shares to UBS Limited, an English corporation, for a purchase price per Paired Share of $28.8125, or aggregate consideration of approximately $93.6 million. In connection with this private placement, the Companies also entered into an agreement with Union Bank of Switzerland, London Branch ("UBS") which provides for an adjustment of the purchase price of the Paired Shares as of a specific date. Because the Companies must periodically increase their equity base to maintain financial flexibility and continue with their growth strategy, management may utilize private placements of equity, in conjunction with a price adjustment mechanism, as a means for the Companies to raise capital, while also retaining the opportunity to

adjust the pricing of the equity issuance during the term of the agreement. The price adjustment agreement with UBS provides that if the aggregate return on the 3,250,000 Paired Shares issued does not exceed the calculated forward yield (which is based upon the three-month LIBOR rate plus 1.40%) as measured from time to time, the Companies will be required to issue to UBS additional Paired Share with a market value equivalent to the yield deficiency. Conversely, if the aggregate return on the issued shares is in excess of the calculated forward yield, a portion of the Paired Shares originally issued by the Companies will be returned. In addition, the Companies are required to register Paired Shares with the Securities and Exchange Commission to settle its obligations under the agreement. Under certain market conditions, UBS has the right to accelerate the settlement of all or a portion of the transaction. The final settlement date is December 31, 1998. As of December 31, 1997, the private placement of Paired Shares is accounted for as equity and any subsequent adjustments in the share price will be reflected as an adjustment to equity. Such early settlements may force the Companies to issue Paired Shares at a depressed price to satisfy their obligation under the Forward Contract. UBS-LB may also accelerate the settlement of the entire transaction upon certain events of default under the Companies' indebtedness.

10-K for Patriot American Hospitality Inc, March 31, 1998, available on the EDGAR database of the Securities Exchange Commission, http://www.sec.gov/Archives/edgar/data/16343/0000930661-98-000683.txt (visited June 22, 2001). A later S-3 filing stated:

Because we must periodically increase our equity base to maintain financial flexibility and continue with our growth strategy, we have utilized private placements of equity in conjunction with a price adjustment mechanism as a means to raise capital. We have entered into transactions with three counterparties involving the sale of an aggregate of 13.3 million shares of Paired Common Stock, with related purchase price adjustment mechanisms ("Price Adjustment Mechanisms"), as described in "The Companies--Sales of Paired Common Stock with Price Adjustment Mechanisms." Settlement under one or more of the Price Adjustment Mechanisms could have adverse effects on our liquidity or dilutive effects on our capital stock. As of October 5, 1998, the counterparties to two of the Price Adjustment Mechanisms were entitled to require settlement of transactions. See "The

> Companies--Sales of Paired Common Stock with Price Adjustment Mechanisms--PWFS Transaction" and "--UBS Transaction." If the reset price or unwind price (in the case of the UBS and Nations transactions) or the market price (in the case of the PWFS transaction) of the Paired Common Stock is less than the applicable forward price or reference price on a given settlement date or interim settlement or reset date, we must deliver cash or additional shares of Paired Common Stock to effect such settlement, interim settlement or reset. Delivery of cash would adversely affect our liquidity, and delivery of shares would have dilutive effects on our capital stock. Moreover, settlement (whether by reason of a drop in the price of the Paired Common Stock or otherwise) may force us to issue shares of Paired Common Stock at a depressed price, which may heighten the dilutive effects on our capital stock. The dilutive effect of a stock settlement and the adverse liquidity effect of a cash settlement increase significantly as the market price of the Paired Common Stock declines below the applicable forward price or reference price.

S-3 for Patriot American Hospitality Inc, October 5, 1998, available on the EDGAR database of the Securities Exchange Commission, http://www.sec.gov/Archives/edgar/data/16343/0001047469-98-036446.txt (visited June 21, 2001). Given this disclosure of the risks involved with the forward equity contracts, no reasonable jury could determine that the market was unaware of the risk.

Plaintiffs have moved to strike the excerpts from SEC filings that defendants submitted with the O'Donnell declaration. The court, however, has not relied on these excerpts. Instead, the court has relied on the actual filings with the SEC. Thus, to the extent plaintiff's motion to strike is premised on authenticity grounds, it is rendered moot. Plaintiffs also argue that the court should not consider the SEC filings because they were not attached to or referenced in the complaint.

Defendants have also argued, however, that the court may consider the documents in the motion to dismiss because they are subject to judicial notice under FRE 201. The court agrees. In MGIC Indem Corp v Weisman, 803 F2d 500, 504 (9th Cir 1986), the Ninth Circuit held that a court may consider official records in a motion to dismiss. See also William W Schwarzer, A Wallace Tashima and James M Wagstaffe, Federal Civil Procedure Before Trial § 9:212.15 at 9-56 (Rutter Group Practice Guide, 2001). The Second Circuit has adopted a more narrow rule permitting consideration of public documents filed with the SEC in securities class action cases. See Kramer v Time Warner Inc, 937 F2d 767 (2d Cir 1991). The MGIC and Kramer rules have found support in the district courts of the Ninth Circuit. See Plevy v Haggerty, 38 F Supp 2d 816, 821 (CD Cal 1998); Allison v Brooktree Corp, 999 F Supp 1342, 1347 (SD Cal 1998). In the absence of Ninth Circuit authority rejecting MGIC, the court must conclude that the SEC filings that defendants ask the court to consider can properly be considered.

The court declines, however, to rely on the compilations of excerpts from SEC reports submitted by defendants. Plaintiffs have questioned the accuracy of these submissions. In light of the ease with which the court was able to obtain the documents on the SEC's web site, there is no need to consider further the admissibility of the excerpts. Since the court has not relied on exhibits B-D of the O'Donnell declaration, plaintiffs motion to strike is DENIED as moot.

Having considered the disclosures with respect to the forward equity contracts made in Patriot's SEC filings, the court concludes that no reasonable jury could determine that the market was unaware of the risks involved with those transactions. Consequently, the court concludes that plaintiffs' claims based on failure to disclose the risks of the forward equity contracts must be dismissed. As a result, defendants' statement regarding the forward equity transaction cannot give rise to liability.

<u>March 27, 1998, Press Release, ¶ 41.</u>

13. "We remain convinced that the paired-share structure is a legitimate and efficient vehicle for providing continued and long-term value to shareholders."

14. "This proposed legislation will not deter Patriot from continuing its proven internal and external growth strategies which, in 1997, drove Patriot's market capitalization from $1.1 billion to more than $5 billion."

Plaintiffs fail to provide any reasons why these statements are false. The complaint vaguely refers to certain "management communications concerning the legislation" as well as defendants' rush to complete transactions before the bill's effective date. Open Market Complaint at ¶ 42. Neither allegation alleges that defendants did not believe that the paired-share structure remained viable or that continued growth was not possible. With respect to these statements, falsity has not been pled adequately.

<u>April 6, 1998, Press Release, ¶ 43.</u>

15. The release allegedly announced a private placement of Patriot stock to Paine Webber.

Plaintiffs allege this statement to be false for all the same reasons the February 27, 1998, was alleged to be false, plus the reasons stated in paragraph 42 why the March 27, 1998, press release was false. See id at ¶ 44. Since paragraph 42 provides no reasons, this allegation is the same as that concerning the February 27, 1998, press release. Consequently, for the reasons stated above, plaintiffs fail to state a claim based on the April 6, 1998, press release.

May 4, 1998, Press Release, ¶ 45.

16. Patriot announced that funds from operations (FFO) more than tripled in the quarter.

17. "Patriot American's profitability reflects our progress in both internal operations, the successful integration of several completed acquisitions, including Wyndham, our core upscale brand, and our seasonally strong first quarter."

18. "Looking ahead, the ongoing integration of our acquired properties and companies, coupled with the application of these companies' best practices and collective management expertise, create the opportunity for further improvements in profitability over last year's levels."

19. "The integration of our recent acquisitions is on track and is providing opportunities to implement proven successful business practices throughout our portfolio."

These statements are alleged to be false for the following reasons:

- Patriot lacked internal financial controls. ¶ 31(a).
- Patriot had disbanded its internal audit team in 1996 and when it came back in August 1998 it was undertrained and understaffed. ¶ 31(b).
- Profit Projection reports reflected improvements to Grand Bay/Carefree Resorts that never occurred and projected RevPAR was based on renovations that were not occurring. ¶ 31(c).
- Patriot lacked a centralized computer system to permit downloading of sales information to corporate headquarters; Patriot had an unqualified and unstable regional management staff; Patriot canceled certain perks at its hotels (like free breakfasts). ¶ 31(d).
- Budget Up-date Reports showed that Patriot could not pay its short-term debt from funds generated by its properties; these reports were sloppy. ¶ 31(e).
- There was no realistic plan for cutting expenses and achieving $100 million in cost savings and that Patriot's short-term method of showing cost savings, cutting advertising, eliminating travel incentives and stalling on necessary renovations, would have the long term impact of elevated vacancy rates. ¶ 34.

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- Pending legislation would cause Patriot's stock price to drop. ¶ 34.
- There were no procedures in place to integrate Wyndham and Patriot; there was no audit team; and Patriot relied on unaudited accounting statements of the acquired properties. ¶ 36.
- Patriot's FFO figures were false because Patriot improperly avoided taxation on Wyndham's profits by having Wyndham pay excessive lease and overhead payments to Patriot. ¶ 36.
- Patriot did not disclose the true risk of forward equity contracts. ¶ 39(a).
- Patriot did not disclose that Paine Webber had advised against forward equity contracts. ¶ 39(b).
- Mike Grossman, President and COO of Performance Hospitality Management pressured property managers to report unrealistically high RevPAR estimates. ¶ 46.

Open Market Complaint at ¶ 46 (referring to ¶¶ 31, 34, 36, 39 and 42).

Statement 16 is alleged to be false, like statement 9, which also pertained to an FFO announcement. But like the allegations surrounding that statement, the allegations here do not give rise to a strong inference of scienter. Plaintiffs fail to allege reasons why statement 17 is false. Plaintiffs repeat the allegation from paragraph 36 that as of February 12, 1998, Patriot had no procedures in place to integrate Wyndham. This does not mean, however, that by May 4, 1998, Patriot had not successfully integrated Wyndham. Statement 17 refers to Patriot's profitability, making the omission of Patriot's alleged tax evasion (from paragraph 36) misleading. But as discussed in connection with the February 12, 1998, press release, plaintiffs have not pled facts giving rise to a strong inference that defendants knew about this alleged sheltering. Otherwise, statement 17 is not alleged to be false.

It is not clear how statement 18 is alleged to be false. The statement is a projection that profit for the upcoming quarter will improve based on integration of hotels, application of "best practices" and management expertise. Plaintiffs have not alleged that these factors were impermissibly relied on by defendants or that facts regarding these factors were withheld. Additionally, this statement appears to be a forward-looking statement. It is a profit projection and thereby embraced by 15 USC § 78u-5(i)(1)(C). The statement was accompanied by the following cautionary language:

> This press release contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. The Company's actual results could differ materially from those set forth in the forward-looking statements. Certain factors that might cause such a difference include competition for guests from other hotels, dependence upon business and commercial travelers and tourism, the seasonality of the hotel industry, availability of equity or debt financing at terms and conditions favorable to the Companies, and the status of proposed tax legislation regarding the paired-share structure.

5/4/98 Press Release, O'Donnell Decl, Exh A, at 7.

Statement 19 is like statement 17 in that both assert that integration is going well. As discussed above, plaintiffs fail to allege that as of May 4, 1998, integration was not going well. For these reasons, the May 4, 1998, press release cannot give rise to liability.

<u>July 9, 1998, Press Release, ¶ 55.</u>

20. "Our company has been one of the most dynamic acquirers and consolidators in the lodging and REIT industries... strong testimony to the leadership, vision and market savvy of Paul Nussbaum, chairman and chief executive officer of Patriot American, as well as other members of our senior management

team."

21. "We are building a company for the long-term, one that can withstand inevitable economic fluctuations."

22. "We strongly reject the notion that we have not proven that we can operate what we have acquired. Our operating fundamentals have been, and will continue to be, strong."

23. "We are optimistic that in a year where most lodging companies are expected to achieve RevPAR growth for the full year in the single digits, we will outperform our competitive set with the potential of achieving double-digit RevPAR growth."

24. "We are comfortable with our current leverage and reiterate our commitment to long-term operating strategies designed to weather short-term contractions in our stock price, as well as industry fluctuations."

The press release is alleged to be false for all the same reasons given previously. They are:

- Patriot lacked internal financial controls. ¶ 31(a).
- Patriot had disbanded its internal audit team in 1996 and when it came back in August 1998 it was undertrained and understaffed. ¶ 31(b).
- Profit Projection reports reflected improvements to Grand Bay/Carefree Resorts that never occurred and projected RevPAR was based on renovations that were not occurring. ¶ 31(c).
- Patriot lacked a centralized computer system to permit downloading of sales information to corporate headquarters; Patriot had an unqualified and unstable regional management staff; Patriot canceled certain perks at its hotels (like free breakfasts). ¶ 31(d).
- Budget Up-date Reports showed that Patriot could not pay its short-term debt from funds generated by its properties; these reports were sloppy. ¶ 31(e).
- There was no realistic plan for cutting expenses and achieving $100 million in cost savings and that Patriot's short-term method of showing cost savings, cutting advertising, eliminating travel incentives and stalling on necessary renovations, would have the long term impact of elevated vacancy rates. ¶ 34.
- Pending legislation would cause Patriot's stock price to drop. ¶ 34.

- There were no procedures in place to integrate Wyndham and Patriot; there was no audit team; and Patriot relied on unaudited accounting statements of the acquired properties. ¶ 36.

- Patriot's FFO figures were false because Patriot improperly avoided taxation on Wyndham's profits by having Wyndham pay excessive lease and overhead payments to Patriot. ¶ 36.

- Patriot did not disclose the true risk of forward equity contracts. ¶ 39(a).

- Patriot did not disclose that Paine Webber had advised against forward equity contracts. ¶ 39(b).

- Mike Grossman, President and COO of Performance Hospitality Management pressured property managers to report unrealistically high RevPAR estimates. ¶ 46.

Open Market Complaint ¶ 56 (referring to ¶¶ 31, 34, 36, 42, 46).

Plaintiffs fail to allege the falsity of statement 20. Statement 21 says that Patriot is building a long term company. If the allegations that renovations were not occurring (¶ 31(c)), cost savings techniques would have a negative long-term impact (¶ 34) and coercion on property managers to inflate RevPAR numbers are true (¶ 46), these facts tend to make that statement misleading. Arguably, falsity is alleged. But the pleading with respect to these allegations lacks the requisite specificity to give rise to a strong inference of fraudulent intent. Plaintiffs do not allege any evidence that would indicate that defendants knew about the stalled renovations or the negative impact of the cost savings techniques implemented. Nor do plaintiffs allege the source of their information about the pressure put on property managers. Without that information, the court cannot conclude that plaintiffs have pled facts giving rise to a strong inference that defendants knew about such coercion.

Statement 22 states that Patriot's operating fundamentals are strong. While it is difficult to discern precisely what might constitute an operating fundamental, the allegations about faulty financial controls (¶ 31(a)), no audit team (¶ 31(b)), no computer system and unstable regional management (¶ 31(d)) might all indicate the falsity of the statement. But as discussed above, the allegation with respect to faulty financial controls is vague; one can only speculate what plaintiffs allege is wrong with defendants' statement. With respect the audit team, computer system and regional management, even if falsity is pled with particularity, plaintiffs have not pled facts giving rise to a strong inference of scienter. Did defendants know about the audit team, the computer system and the regional management? From the complaint it is not clear how they would have.

Statement 23 is a prediction of RevPAR growth. Falsity is pled in paragraphs 31(c) and 46. While the statement is forward-looking, plaintiffs allege omissions of contemporaneous fact. Thus the safe harbor is unavailable. Again, however, plaintiffs have failed to plead scienter adequately. Plaintiffs have pled the existence of no evidence that would show that the defendants sanctioned the RevPAR improprieties alleged in the complaint.

Statement 24 is about Patriot's comfort with its level of debt. Plaintiffs allege that Patriot could not meet its short term debt obligations (¶ 31(e)). Thus, falsity has been pled. But the allegation about Budget Up-date reports is too vague. <u>Silicon Graphics</u> makes clear that specific information about reports (date, recipients, author and content) must be pled. Plaintiffs have failed to do this. Thus, plaintiffs have not pled facts giving rise to a strong inference of scienter.

<u>July 22, 1998, Press Release, ¶ 59.</u>

25. "We maintain that the paired-share structure is a successful business arrangement that provides high returns to shareholders; however, Patriot American accepts the fact that under the new law, it is precluded from making new acquisitions as a paired-share REIT, with a retroactive effective date of March 26, 1998."

26. "As soon as the Clinton Administration proposed curbing the growth of paired-share REITS in its 1999 budget submission, Patriot began to consider alternatives to its paired-share structure."

27. "The most important point for our shareholders to understand is that we remain committed to our pre-March 26 growth strategy, albeit within a new and dynamic structure which we hope to announce very soon."

28. "We will continue to focus on internal growth opportunities through property conversions to our core Wyndham brand, as well as realizing meaningful cost savings facilitated by our successful integration of nine acquired companies."

29. "In short, we are proud of the success we enjoyed as a paired-share REIT, we are highly confident that regardless of our structure going forward, we will continue to enjoy internal and external growth while emerging as a world-class hotel company."

These statements are alleged to be false for all the reasons stated above, those contained in paragraphs 31, 34, 36, 39, 42, 44 and 46. Additionally, plaintiffs give the following reasons that the statements are false:

- Defendants had not focused on the long term; Patriot was experiencing massive turnover at the management level and defendants had no plans for achieving growth in revenues now that acquisitions were no longer an option.

- The dilution in Patriot stock due to the forward equity contracts would have an adverse effect of funds from operations per share and earnings per share in the future.

- Patriot began to place vendors on a 60-day payment plan, rather than a 30 day plan.

Open Market Complaint ¶62(a).

Plaintiffs fail to allege any reason why statement 25 is false. None of the reasons given by plaintiffs shows that a paired-share structure is not a successful business arrangement. Nor have plaintiffs alleged that statement 26 is false; plaintiffs do not allege that defendants did not consider alternatives to the paired-share structure. Statement 27 claims that Patriot is committed to its pre-March 26 growth strategy. But plaintiffs allege that defendants had no strategy for continued growth now that acquisitions were not an option. Thus, plaintiffs allege falsity. While the statement might be seen as forward-looking, defendants have not identified it as such and have not pointed to any cautionary language that accompanied it. See O'Donnell Decl, Exh A. For this reason, safe harbor protection is not available. The allegation that defendants lacked a plan for growth, however, is not pled with enough detail to give rise to a strong inference of scienter. Plaintiffs simply assert that defendants lacked a plan. They make no mention of how this was discovered or what evidence will show the lack of growth plans.

Statement 28 references cost savings and integration. Plaintiffs have alleged that defendants' cost savings plan was ineffective. See Open Market Complaint ¶ 34. But as discussed above, plaintiffs have failed to plead the detail necessary to show scienter on the part of defendants. The facts pled do not give rise to a strong inference that defendants knew their cost savings plan would fail. Plaintiffs have also made allegations about Patriot's ability to integrate new acquisitions. See id at ¶ 36. But the allegation is that at the time of the Wyndham acquisition there was no integration plan in place. This does not mean that later integration efforts were failing.

Statement 29 predicts continued external and internal growth. Plaintiffs have alleged that defendants had no plan for continued growth. But, as discussed above, the allegation that defendants lacked a plan does not include sufficient detail to give rise to a strong inference of scienter.

July 29, 1998, Press Release, ¶ 60.

30. "We are pleased with our second-quarter results, which we believe illustrate our ability to achieve operational excellence amidst the intense completion of several key corporate acquisitions including Interstate Hotels Company, Arcadian International and Summerfield Hotel Corporation. These three transactions, representing an aggregate investment of approximately $2.7 billion * * * ."

31. "With regard to passage of the IRS Restructuring Bill, we expect to ... enjoy significant internal and external growth, sometime in the third quarter. We are proud of our dynamic progress and expect that continued application of our acquired companies' best practices will further enhance our profitability in the coming quarters ...."

The statements are alleged to be false for all the same reasons the July 22, 1998, statements were alleged to be false. With respect to statement 30, the court cannot conclude that plaintiffs have pled falsity. Statement 31 makes predictions about future growth. The statement is alleged to be misleading because it fails to disclose that Patriot (allegedly) had no plan for growth after passage of the Restructuring Bill. But as discussed previously, plaintiffs fail to allege facts giving rise to a strong inference of scienter.

September 16, 1998, Press Release, ¶ 61.

32. "The decision to maintain the paired-share structure is consistent with Patriot American and Wyndham International's

priority of maximizing the Company's internal growth potential. * * * we could not ignore the simple fact that the acquisitions we've completed this far are protected within the language of the IRS Restructuring Bill."

33. "This amassed portfolio will continue to provide us with significant internal growth opportunities. We believe very strongly in the viability of our internal growth strategy, which focuses on broadening the distribution among our existing assets of our core Wyndham and Grand Bay proprietary brands, continuing to realize economies of scale through the integration of our acquired companies, and managing our properties so as to continue to enjoy one of the highest operating improvements in the industry."

34. "maintaining the current structure underscores the boards of directors' confidence in the Companies' management expertise and enables the company to continue with its aggressive brand distribution strategies. We are proud of our accomplishments as a paired-share REIT, not the least of which has been amassing the most experienced and highly regarded hospitality management team in the industry."

35. "we believe that we are well-poised to reap continued benefits from our aggressive acquisition pace over the past 12 months while increasing the distribution and elevating the status of our proprietary brands. Today's announcement marks a pivotal moment of our companies, one that represents an inordinate amount of time, analysis and deliberation, but one that also reiterates our confidence in the Companies' fundamental strengths."

36. "Clearly, we are now in a position where we are not dependent on future acquisitions to grow."

37. "As a responsible company focused on the long term, we and our boards regularly review our strategies and our objectives in order to ensure that we continue to maximize shareholder value."

38. "In total, we are confident that electing to maintain our existing structure provides us with a clear and efficient path to continued internal growth. Similarly, we continue to believe that maintaining the paired-share REIT structure enables us to maintain our financial flexibility, protecting both our funds from operations and our dividend stream and, thereby, continuing to provide shareholders the best possible return on their investment."

Plaintiffs allege falsity for all the reasons alleged with respect to the July press releases. The focus of the statements is on Patriot's pursuit of internal growth via its brand distribution plan. Patriot expresses confidence that it can achieve revenue growth by converting its acquired properties to the Wyndham brand. Plaintiffs allege falsity based on their allegation that "had no plan for achieving growth in revenues now that the acquisition scheme had been put to a halt." Open Market Complaint ¶ 62(a). The allegation, if true, would make Patriot's statements about its brand distribution plan for realizing growth misleading. But plaintiffs have not alleged specific facts that would give rise to a strong inference that while defendants were touting this brand distribution plan they in actuality had no plan whatsoever.

November 8, 1998, Press Release, ¶ 64.

39. "While many of our accomplishments this quarter related to integration, property conversions, operating improvements and broadened visibility for our core brands have been greatly diminished by significant world events * * * we remained and will continue to be focused on our industry-leading operational excellence."

40. "Assuming acceptable resolution of these issues and given the excellent results submitted for the month of October, we expect to reach consensus FFO per share estimates, in aggregate, for the second half of 1998. In total, while this quarter has not been our most successful due to the delay of certain transactions we expected to occur in the third quarter, we remain convinced that we are building a powerhouse company for the long term."

41. "Overall, we are pleased with our operational performance this quarter and attribute the significant RevPAR increase of many of our converted properties to the strength of our dramatically growing brand... We also are extremely proud of the performance of our European properties that we acquired earlier this year as part of the Arcadian International transaction; the 11 Arcadian properties which we expect to re-brand next year collectively achieved an impressive RevPAR increase of 9.3%, with the Malmaison properties reporting a 15.2% increase, We look forward to achieving even greater improvements once these properties are added tour central reservations system."

The statements are alleged to be false for the reasons stated in paragraphs 31, 34, 36, 42 and 62 of the complaint. It is hard to discern precisely why plaintiffs think the statements are false. Plaintiffs state that Patriot was using its press releases to "condition the market to believe that cost savings and internal growth would fuel earnings." Open Market Complaint at ¶ 64. Plaintiffs have alleged that Patriot's cost savings techniques were flawed (id at ¶ 34) and that Patriot had no plans for internal growth (id at ¶ 62). But the court has already concluded that these allegations were not pled with enough detail to give rise to a strong inference of scienter. So again, plaintiffs fail to meet the pleading requirements of the PSLRA.

<u>November 18, 1998, Press Release, ¶ 67.</u>

42. "We look to these two businesses to expand our presence in the UK and into Europe, and to introduce our own Wyndham values of service and product consistency, for which we are renowned in the North American lodging industry, to these important global markets * * * ."

Plaintiffs allege falsity as follows: "as a result of Patriot's extreme cash crunch, rather than 'expand[ing its] presence in the UK and into Europe,' defendants had already put Arcadian International (one of its more profitable European properties) up for sale. Id at ¶ 68. This allegation, however, does not plead falsity with the specificity required by FRCP 9(b) and the PSLRA. Is the Arcadian International property just one of the Arcadian properties? If so, how does this make defendants' statements false? More specificity is required.

<u>December 16, 1998, Press Release, ¶ 73.</u>

43. "[Patriot] announced today that it has entered into a letter

of intent with a group of investors to make a $1 billion equity investment in the Company."

44. "This investment will provide the foundation for our recapitalization plan which will include the repayment of maturing debt and settlement of forward equity obligations."

45. "This investment represents a strong vote of confidence from the investment community in Patriot's hotel operating capabilities and the strategic growth of its proprietary brands."

46. "The Preferred Stock, when issued, will be convertible into common shares at the lesser of $10.00 or 122.5% of Patriot's average closing price for the 20 trading days ending 10 days immediately preceding the date of the shareholder vote to approve the investment, but not less than the closing bid price as of December 15, 1998."

47. "If the Company enters into an alternative transaction with a third party, the Company will be obligated to pay the Investors $30 million and reimburse the Investors for certain expenses."

Plaintiffs allege that these statements were false for the reasons stated in paragraphs 31, 34, 36, 39, 42 and 62. Additionally, and more on point at least, plaintiffs allege: "defendants knew that these statements were materially false and misleading because they knew, but failed to reveal, that this 'equity infusion' was actually a sale of control of Patriot for an inadequate price and to the detriment of Patriot's non-controlling public shareholders." Id at ¶ 74.

Plaintiffs' assertion that defendants needed to characterize the "equity infusion" differently fails as a matter of law. Defendants were not required to editorialize about the facts disclosed. See Valley Nat'l Bank v Trustee for Westgate-California Corp, 609 F2d 1274, 1282 (9th Cir 1979). To the extent defendants knew the deal was bad for Patriot, the court agrees that the failure to disclose that information could be misleading. But plaintiffs' mere assertion that defendants knew the terms of the

Apollo transaction were bad cannot meet the scienter pleading requirements of the PSLRA and Silicon Graphics.

In sum, plaintiffs complaint largely fails to plead the falsity of the statements it excerpts, at length, in the complaint. Little attempt is made to link specific statements to the reasons given for falsity. In a number of instances, the court has determined that plaintiffs do allege falsity, but the allegations lack particularity. The alleged failure to disclose the risks inherent in the forward equity transactions fails under the truth-on-the-market doctrine. The remaining alleged misstatements fail because plaintiffs do not plead facts in sufficient detail to meet the standards of the PSLRA and Silicon Graphics for pleading scienter.

3

While the individual allegations fail to give rise to a strong inference of scienter, the court must also consider plaintiffs more general allegations of scienter contained in paragraphs 78 to 84. Plaintiffs make the following allegations:

- "Nussbaum and Carreker, the top executives of Patriot, ran Patriot as 'hands-on' managers, dealing with important issues facing Patriot's business." Open Market Complaint at ¶ 79.
- "Nussbaum and Carreker closely monitored Patriot's business via reports such as weekly and monthly profit and loss reports and weekly forecasts (also referred to as "rolling forecasts") that were provided by each property group's management, and flash reports, which contained daily RevPAR, were provided by e-mail each Thursday from the individual properties. The monthly profit and loss report was due to Nussbaum and Carreker on the fifth day of the month. Nussbaum and Carreker discussed these reports in Monday morning meetings in Dallas." Id at ¶ 81.
- "Nussbaum and Carreker were motivated to keep the paired-share price high, as defendants intended to use, and actually did use, inflated Patriot stock to make acquisitions." Id at ¶ 83.

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- "Nussbaum and Carreker were also motivated to act against shareholder interests when they sold control to the Apollo Group at a discount because defendants were able to preserve their own business relationships for future deals with this investment group and provide themselves with golden parachutes." Id at ¶ 84.

Essentially, plaintiffs argue that defendants knew about the falsity of their statements because they were top executives, used a hands-on management style, the items at issue were important and defendants had access to internal reports. Plaintiffs also allege motive and opportunity. The motives alleged are keeping the share price high to facilitate acquisitions and obtaining good compensation packages upon the buyout.

Plaintiffs argue that this is sufficient to give rise to a strong inference of scienter. Plaintiffs contend that knowledge of the status of important aspects of Patriot's business should be imputed to the defendants. Plaintiffs cite Epstein v Itron, Inc, 993 F Supp 1314 (ED Wash 1998), for the proposition that: "facts critical to a business's core operations or an important transaction generally are so apparent that their knowledge may be attributed to the company and its key officers." Id at 1326.

Epstein, however, was a pre-Silicon Graphics case. More recent cases have questioned the vitality of the Epstein presumption. In re Read-Rite Corp Sec Lit, 2000 WL 1641275 at *6 (ND Cal 2000); In re Splash Technology Holdings, Inc Sec Lit, 2000 WL 1727377 at *21 (ND Cal 2000). The court in Read-Rite "assum[ed] without deciding that the Epstein presumption [was] alive in the Ninth Circuit after Silicon Graphics" but then went on to eviscerate the doctrine. Read-Rite, 2000 WL 1641275 at *6. It stated: "One reasonably could infer that a person with the duties of the individuals would be aware of the falsity of some or all of the statements at issue, but 'under current law, the mere existence of a reasonable inference does not satisfy the Reform Act's requirement of a strong implication.'" Id. The court in Splash was less equivocal. It stated:

> Ancor and Chalverus suggest that alleging the existence of undisclosed critical facts in concert with a defendant's prominent role in the corporation may support a strong inference that the defendant acted with deliberate recklessness when he made allegedly false or misleading statements. Such an approach, however, is not likely viable in the aftermath of Silicon, which bemoaned the absence of details about internal reports-such as their specific content, drafters and reviewers.

Splash, 2000 WL 1727377 at *21. The court finds Splash persuasive. The Epstein presumption cannot survive Silicon Graphics. Plaintiffs must do more than allege that defendants were top executives who employed a hands on style and that the issues were important to the company.

Furthermore, plaintiffs' allegation that defendants had access to numerous internal reports is insufficient since the complaint makes no specific reference to individual reports that would support plaintiffs allegations. After Silicon Graphics, it is simply not enough to say generally that defendants had access to reports.

The remaining scienter allegations amount to mere motive and opportunity allegations. Plaintiffs allege no stock sales by defendants during the class period. In support of their argument that defendants' need to keep share price high to facilitate acquisitions provides motive, plaintiffs rely principally on cases from the Second Circuit. But the Ninth Circuit, in Silicon

Graphics, expressly rejected the Second Circuit motive and opportunity approach to pleading scienter. Silicon Graphics, 183 F3d at 974-975. Thus, plaintiffs motive and opportunity allegations cannot alone support a finding that scienter has been adequately pled.

As shown above, plaintiffs have failed to augment their motive and opportunity allegations with specific allegations that would give rise to a strong inference of fraudulent intent. Consequently, the court must conclude that plaintiffs have failed to comply with the pleading requirements of the PSLRA, as interpreted by Silicon Graphics. Because the court has determined that plaintiffs' section 10(b) claims must be dismissed, plaintiffs' section 20(a) claim must also be dismissed. In re Verity, Inc Sec Lit, 2000 WL 1175580, at *7 (ND Cal 2000). With respect to the section 10 claims arising out of undisclosed forward equity risks, the complaint is dismissed without leave to amend. In all other respects, the open market complaint is dismissed with leave to amend.

The court concludes beyond doubt that the lengthy recitals of the open market complaint, as presently framed, do not plead an actionable claim of securities fraud. Dismissal is, therefore, appropriate. The court does not conclude that out of the morass of undigested facts plus additional available facts plaintiffs cannot craft a pleading that could meet the requirements of the PSLRA and Silicon Graphics; certainly, the court does not conclude that defendants met their obligations under the securities law. But plaintiffs have not sufficiently defined defendants' alleged misconduct to permit the present complaint to go forward.

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C

Finally, because the court will allow the open market plaintiffs an opportunity to amend, the court offers the following suggestions. Although both complaints are overlong and unduly prolix, the open market complaint framed as it is with long quotations from various documents is virtually incomprehensible. Lengthy contemplation of this complaint has cast little illumination.

The particularity required by the PSLRA and Silicon Graphics does not mandate a pleading that is distended and metastatic with detail. Ronconi v Larkin, 2001 WL 609520 (9th Cir 2001), is instructive. In that case, the court of appeals concluded that plaintiffs failed to plead facts in sufficient detail to give rise to a strong inference of scienter. As in this case, the Ronconi plaintiffs failed to point to internal documents seen by defendants or contemporaneous statements by defendants that would indicate that their generally optimistic statements were not believed when made. At one point the court of appeals said: "We cannot discern what statements the complaint says were false or misleading nor the basis for concluding they were made intentionally or with deliberate recklessness." Id at *5. This court has had similar difficulties with the open market complaint. Significantly, the Ronconi court noted that the various requirements of pleading securities fraud are "not satisfied merely by making a complaint long." Ronconi, 2001 WL 609520 at *10.

Should plaintiffs choose to amend their complaint, the court urges plaintiffs to link the alleged misstatements and the reasons why the statements are false tightly. In the present open market complaint, press releases several paragraphs long are excerpted and numerous lines are highlighted. Then the entire paragraph is alleged to be false. Plaintiffs must isolate the falsity, allege clearly the reasons for the falsity and allege the reasons defendants knew of the falsity. The court suggests that with respect to each misstatement, the amended complaint adhere to the following format:

> "On [date], defendants stated [succinct substance of statement]. This statement was false because [reason]. Defendants had actual knowledge of the falsity in that [reason]."

With respect to each misleading omission, the court suggests a format such as:

> "On or about [date], defendants knew or became aware of [succinct statement of fact]. Defendants acquired their knowledge from [source]. Defendants were under a duty to disclose this fact but failed to do so."

Each alleged misstatement or omission should be set forth, in substance, in a separately numbered paragraph together with the reasons that it was false and the basis for the allegation that it was made with actual knowledge of its falsity. Brevity and directness of these allegations will greatly assist in moving the case forward.

Plaintiffs shall submit an amended complaint, if they wish to, on or before October 1, 2001.

IV

In sum, Patriot and Paine Webber's motions to dismiss the merger complaint (Docs #2-1 and 4-1) are GRANTED. The merger plaintiffs may submit an amended complaint with respect to the claims not dismissed with prejudice. That is, the merger plaintiffs may amend their complaint with respect to the following claims only:

- the omission of defendants' intention to take on an *exorbitant* amount of debt;
- the omission of defendants' intention to assume debt in the form of forward equity contracts or debt having such terms that the failure to disclose such intention would significantly alter the total mix of information available to investors; and
- the misrepresentation claim related to the allegedly misleading valuation by Paine Webber.

As to Paine Webber, however, the dismissal of these claims, to the extent they arise under section 12, is with prejudice. The remaining merger claims are dismissed with prejudice. An amended complaint shall be filed on or before October 1, 2001.

Patriot's motion to dismiss the open market action (Doc # 13-1) is also GRANTED. The claim that defendants failed to disclose the risks associated with the forward equity contracts is dismissed with prejudice. The remaining claims are dismissed without prejudice to the filing of a short, plain statement of plaintiffs' open market claims in an amended complaint to be filed on or before October 1, 2001.

Plaintiffs' motion to strike (Doc #21-1) is DENIED as moot.

IT IS SO ORDERED.

VAUGHN R WALKER
United States District Judge